GLOBAL FINANCIAL INFORMATION, COMPLIANCE INCENTIVES AND CONFLICT FUNDING

The current campaign to interdict terrorist funds is a priority for international economic cooperation. However, it has proved very difficult to ensure timely reporting of the financial transactions of targeted individuals or groups, or to deny them access to the international financial system. This paper examines the economics of coordinated financial interdiction of criminal transactions, the role of unregulated money transfer networks and the problem of offshore financial centres. The limited success of recent multilateral and unilateral attempts to further strengthen regulatory controls on international banking and informal transfer systems can be attributed to existing economic incentives working against the regulatory disclosure of the identity and purpose of transacting agents. The paper concludes that possible policy solutions might involve the application of withholding taxes to render transactions with unregulated clients unprofitable, and the provision of affordable transfer systems for migrant remittances.

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1. **INTRODUCTION**

Since the terrorist attacks of 11-ix-01 on New York, financial crime in general and terrorist financing in particular have occupied the attention of international organisations and national governments throughout the world. In the succeeding nine months, transborder cooperation on the provision of financial information has been strengthened, led by Washington and London in their role as not only geostrategic allies but also as regulators of the two major global financial centres. More than 112 countries have issued orders blocking the terrorist assets, with approximately US $100 million frozen. However, closer examination reveals that it has proved very difficult to ensure timely reporting of the financial transactions of targeted individuals or groups, or to deny them access to the international financial system. Existing measures and multilateral arrangements to combat money laundering and drug smuggling have been co-opted to deal with the issue of terrorist financing without adequate evaluation of the limitations imposed by fiscal and cost incentives on the one hand, and the by the asymmetric governance of the existing intergovernmental bodies on the other.

Within the limitations of the information publicly available, this paper sets out to explore this problem from the viewpoint of the economics of financial regulation. The key issue

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1 I would like to thank Rachel Ziemba of St Antony’s College for research assistance; and the Carnegie Foundation for funding.

2 The important issue of who determines which individuals or groups are to be internationally defined as terrorists lies beyond the scope of this paper. There is an obvious danger that autocratic governments will define all opposition – especially self-determination movements – as terrorism.

3 However these limitations illuminate the process and the value given to the restriction of terrorist financing by those involved: authorities have to inform the public because interdiction must be implemented through the market. The information available on banking, national and organizational websites is revealing in this respect. At the national level this differentiation based on resources is particularly marked. While most states have accepted the UN resolution, they lack the resources or the interest for substantial implementation. Thus, the greatest amount of information can be found on the US Treasury’s Financial Crimes website, followed by the UK Treasury. Conversely, other countries, including other members of the G7 such as France, appear much less involved in dissemination. Within organizations, the limited website of the FATF itself is telling. While there are clear statements of the ‘Forty Recommendations’ and of the lengthy new guidelines on the reporting of possible terrorist financing, there are only very limited reports on recent activities. This paucity of information is probably due to the enormous amount of work expected of the FATF, while it has limited resources.
here is the geostrategic need for more information on the identity of transactors and the ability to freeze/expropriate assets and/or gain information on other related activities. To the extent that this involves a loss in efficiency of the market as a whole by increasing transactions costs, there is an economic welfare loss to be set against the strategic welfare gain. There are two obvious parallels here: first, with the trade-off between efficiency and stability in financial markets which brings about the need for prudential regulation to prevent systemic risk (Goodhart et al, 1998); and second with the trade-off between efficiency and equity, where a broader social aim justifies intervening in the market – usually in the form of taxation (Atkinson and Stiglitz, 1980). However, the regulators’ problem here is that the large unregulated flows generated by broadly legal activities such as tax avoidance and migrant remittances provide cover for crime-related transactions.

In the textbook understanding of financial intermediation between saving households and investing firms in economic theory, banks undertake the task of monitoring on behalf of savers because they enjoy scale and learning economies in this activity (Diamond 1984). Further, they have privileged access to the details of depositors’ wealth and transactions – which enables them to provide other financial services and avoid adverse selection at low cost. It is an easy logical step from this to surmise that in consequence banks are in a unique position to provide accurate information on their clients to the regulatory authorities without undue cost. This is probably a false assumption for two reasons. First, monitoring is increasingly done by the market and reflected in traded asset prices; while the banks become asset managers rather than monitors of firms. Second, for high net worth individuals banking secrecy itself is a service generating high fees; and these individuals will rapidly switch banks if this is not offered.4

These kinds of secrecy are at best zero-sum situations, such as concealing assets from family members, but mostly involve tax evasion where the loss is to a national treasury

4 This is not the case for smaller customers, of course lists of whose details are actively marketed by banks to other service suppliers.
and thus presumably a net welfare loss. Indeed, the problem addressed in this paper is the reverse of that analysed in the literature on asymmetric information where it is assumed that the ‘lender’ (i.e. depositor, creditor, asset purchaser) or purchaser of services has insufficient information to properly monitor the ‘borrower’ (i.e. deposit taker, debtor, asset issuer) or supplier of services (Hiller, 1997). In the present case it is the deposit taker or financial services provider who is required to gain and report more information on their clients.

This paper is structured as follows. Attempts to detect and interdict illegal financial flows related to the funding of armed conflict (of which terrorism is a prime but not the only example) are built on existing systems of reporting the use of financial systems for illegal purposes. This foundation is examined in Section 2, which covers multilateral coordination on financial interdiction, the role of unregulated money transfer networks (MTNs) and the problem of offshore financial centres (OFCs). The limitations of this foundation are shown to derive from the bias of economic incentives towards less rather than more disclosure. Section 3 examines recent attempts to strengthen regulatory controls on international banking by both multilateral and unilateral action on the one hand, and the initiative to regulate informal transfer systems on the other. This leads to the conclusion in Section 4 that unless market incentives work with – rather than against – regulatory disclosure, there is little prospect of substantial progress. A possible policy solution would be to apply withholding taxes in such a way to make transactions with unregulated high-wealth clients unprofitable; supported by the establishment of an alternative regulated system for low-cost money transfers by emigrants.

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5 Indeed economic agents always value information transparency about other agents’ activities, but are reluctant to reveal their own – which is why statutory reporting of accounts is found necessary within domestic jurisdictions to overcome a systemic problem of coordination failure.
2. ANTecedents FOR INTERDiction OF FINANCIAL TRANSFERS

Financial Action Against Terrorism

Mechanisms to interdict terrorist financing are inevitably built upon the foundations of those already established for the prevention of financial crime including money laundering. In May 2002, the US Attorney General attested to the interlinked nature of financial crime and terrorist funding: “We find that transnational criminal activity is associated with terrorism” such as drug trade money going to terrorist groups. Ashcroft said, “We need to expand and improve international cooperation to confront the internationalization of criminal and especially terrorist activity”. Existing multi-lateral regulation bodies such as the Financial Action Task Force (FATF), Interpol and the UNDCCP have been involved for a long time in the attempts to coordinate reactions to financial crime of all sorts (Johnson, 2001). In the aftermath of the terrorist attacks of September 2001, it appeared that that the most effective way to counter this threat was to redirect and intensify the efforts of already existing multi-lateral monitoring and coordination bodies.

In the ‘formal sector’ of international banking, the weakest link appears to be the essentially self-regulated international network of correspondent banks (The Economist, 2001). International correspondent banking exists in order that banks may provide a wide range of alternate services for their clients in territories where they have no established branches. This in turn makes these formal financial institutions vulnerable to unwitting collusion in money laundering activities. This problem is most evident when international correspondent banks engage partners domiciled in poorly regulated emerging market countries. These arrangements allow the transfer of both illegally and legally derived money from the unregulated into the regulated financial institutions, thus “allowing funds

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6 [source]

7 Of course there may be collusion by individual bank officers without that of senior management or shareholders.

8 For a more detailed examination of this important topic, see Nawaz et al. (forthcoming).
in through the backdoor of the regulated institutions to commence or continue the laundering process” (Johnson, 2001 p.130).

For banks, attempts to detect and interdict terrorist financing are dealt with through existing mechanisms to counter money laundering. However, while most money laundering funds derive from other criminal offences, such as the sale of illegal drugs, the source of terrorist funds are frequently legal. The banking sector is aware that any action which would be able to limit terrorist financing would require cooperation between banks, between governments and between banks and governments. This cooperation would take the form of information sharing and the creation of new mechanisms to track suspicious behaviour. A group of twelve leading international banks agreed to the ‘Wolfsberg Principles’ for self-regulation in October 2000. These principles were established with assistance from Transparency International (an anti-corruption NGO), and focus on increased due diligence on the part of the banks. In particular, they are expected to be more aware of their customers and their actions. The ‘Wolfsberg Group’ has extended their principles to meet the new concern of terrorist financing, increasing the due diligence expected from their members.

Various United Nations agencies were also previously involved in combating financial crime in general and terrorist funding in particular. Existing UN resolutions, such as the 1999 International Convention for the Suppression of the Financing of Terrorism, were used as a starting point for new action. The perception of new threats gave greater importance to the ratification of existing legislation. Additionally, the UN Security Council and General Assembly have adopted resolutions calling upon all nations to act to stop terrorism and its supporters in all ways. The most powerful of these resolutions, detailing measures to be taken to suppress the financing of terrorist acts is Security Council Resolution 1373. The UN called for increased cooperation from all member states to stop acts of terrorism and the means by which terrorist actions were supported.

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Multilateral monitoring and policy proposing organizations such as the FATF were already concerned with financial crime, in particular money laundering. The FATF was founded in 1989 to coordinate policies against the misuse of the financial system by money laundering. Now including 29 member states and several regional affiliated bodies, it monitors the actions of member states in implementing anti-money laundering policy and promoting such policies around the world. Its ‘Forty Recommendations’ delineate measures for law enforcement agencies, banks and governments. These recommendations are designed to be widely applied, providing flexibility for individual states to apply them in their own jurisdictions. The FATF recommendations are composed of several sections, including the criminalisation of laundering money from crime, the requirement of banks to know their clients, and reporting any suspicious transactions to their governments.\footnote{11} The FATF not only contributes to monitoring but also provides a platform for information sharing among law enforcement and regulatory officials from member states and international organizations. At these annual meetings, member regulators discuss advances changes in money laundering and new ways to counteract it.\footnote{12}

\textit{Informal Financial Systems} \footnote{13}

Multilateral bodies such as the G7 Financial Action Task Force on Money Laundering (FATF), although not regulators as such, exercise an unprecedented level of critical scrutiny on global money transfer networks (MTNs), particularly unregulated or ‘informal’ MTNs such as the hawala system discussed below. The regulatory problems raised by informal MTNs are complex, both because it is very difficult to identify these networks accurately, and because it is unclear how to regulate them even in principle.

\footnote{11 FATF Recommendations [complete source]}

\footnote{12 About the FATF, \url{http://www.fatf-gafi.org/AboutFATF_en.htm}}

\footnote{13 This section has benefited from the useful detail in Nawaz et al (2002).}
All informal MTNs share a common set of operational characteristics, a “lack of records, customer identification or regulatory oversight, and the potential for misuse by criminals” (FATF, 2000). As the FATF outline, the most commonly referred to examples are the Chinese chit or chop system of East and Southeast Asia, the black market peso exchange (BMPE) system of Latin America, and the hawala system, with its offshoot the hundi system in South Asia. Mirroring established migrant labour patterns, smaller IMTNs also provide unregulated (and thus cheaper) remittance services between developed and developing countries.

Unregulated small-scale money transfer network such as hawala systems are used to transfer funds, including cash remittances between two parties both within and across national borders. In India it is suggested that 50 percent of national economic activity makes some use of the hawala system (Stern, 2001). The final settlement between the associate hawaladars may be made through various mechanisms such as bank transfers, reciprocal remittances, manipulation of trade invoices, smuggling of gold or drugs, or through the physical movement of cash by trusted couriers.

Informal MTNs are often held to be ‘archaic’ (Roche, 2001) or ‘underground’ (Gilligan, 2001) financial systems. However, hawala networks can be viewed as a structural response to information asymmetries in the financial services market place and a necessary feature of segmented financial systems. This explains why these networks thrive: they are used predominantly by those consumers, particularly the poor, who are not served by formal financial institutions because of cost and risk. Specifically, they provide a rapid, reliable and relatively cheap means for migrant workers to remit cash to poor and illiterate families.

Given that migrant remittances provide the ‘base load’ for such systems, informal MTNs have two further advantages over the formal financial system. Both of these are the result of the (albeit weak) regulation of the correspondent bank system. First, this type of MTN avoids the additional costs imposed by regulation of banks, for prudential as well as policing purposes. The introduction of international codes and standards by the G7
through the Financial Stability Forum, as well as increased consumer protection, has led to increased costs for banks which are passed on as transactions fees (Bansal, 2001, p. 18). This makes the international transfer of relatively small sums highly unattractive to banks. Second, hawala networks circumvent the record keeping that formal banking involves. Thus they provide the highly valued ‘financial’ service of customer confidentiality similar to that offered by offshore financial centres – particularly for transactions with highly regulated OECD countries.

Although hawala networks rely on traditional forms of personal trust rather than written contracts, they also use formal banking systems and continually respond to the ongoing process of financial globalisation. For example, they are well suited to new e-commerce platforms and form a key element of international ‘cyber-laundering’ business along with gambling, estimated globally to be worth around US$ 50 billion per annum (Philippsohn, 2001). Informal MTNs are increasingly used not only by the poor but also by higher net worth individuals to transfer cash and other assets quickly, relatively cheaply and confidentially to family members or associates abroad. Where these funds come form, or what they are used for, is not the concern of hawaladars – although criminal clients doubtless generate higher commissions.

Offshore Financial Centres

International capital mobility has transformed national tax policy. Present national tax systems were designed in a post-WWII environment of trade protection, capital and labour immobility when very different rates of direct and indirect tax were feasible – but this is no longer the case (Tanzi 1996a, 1998). The role of the tax factor in determining location gives rise to wasteful tax competition for investment (OECD, 1998). This has led to a ‘race to the bottom’ as developing countries compete with other host countries and with declining corporation tax rates in the home countries (UNCTAD, 1995). This form of extreme liberalisation has also involved deregulation of cross-border investment flows,

14 This sub-section is mainly based on FitzGerald (2002).
and thus the information about investors generated thereby. Further, since the tax systems of the major home (i.e. OECD) countries are based on worldwide income taxation principles, their multinational companies are frequently subject to some degree of double taxation. This not only deters international investment, but also provides incentives for the use of tax havens to channel cross-border capital flows through the incorporation of offshore holding companies. The use of these schemes is detrimental to both the home and host country through reduced tax revenues and distorted investment inflows.

The number of double taxation agreements (DTTs) has thus increased rapidly in recent decades, and there are now some two thousand such treaties in existence. The principle of non-discrimination (i.e. national treatment) has been intrinsic to such treaties since the last century; and was central to the draft tax convention prepared by the League of Nations in 1935 (IBFD, 1998). They clearly follow the course of the Bilateral Investment Treaties (BITs) that establish corresponding investor protection disciplines. These treaties, however, become ineffective if offshore centres are used as transfer pricing points as well as for tax avoidance. Moreover, a number of developing countries play a key ‘offshore’ role in the international investment process where tax avoidance is of particular importance. The object here is not so much to attract foreign investment as such, but rather the administration of assets and tax revenue.

While industrialised countries may be able to tax their own residents’ overseas capital gains (JTC, 1999), the tax infrastructure of many developing countries prevents this (IBFD, 1998). The OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters established in 1988 ensures that information on such holding is shared with other OECD governments – but not non-members. Extensive transfer pricing and tax-induced capital restructuring (e.g. intra-firm debt) take place despite the OECD

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15 For instance, Nicaragua since 1995 has completely liberalized foreign investment and thus neither the Central Bank or the government keeps no record of who foreign investors are (let alone the true owner) or the nature of the projects – thus hampering efforts to counter money laundering.
Model Tax Convention and the OECD Transfer Pricing Guidelines which call for the application of market prices to intra-firm transactions (Bartelsman and Beetsma, 2000).

A significant problem associated with this issue is that of offshore financial centres. By allowing multinationals, through transfer pricing, to declare the majority of their profits in shell companies registered in OFCs, the tax revenues resulting from investment and production in (non-OFC) developing countries are lost to the hosts. The Financial Stability Forum (FSF, 2000) has addressed the issue of Offshore Centres (OFCs) from the point of view of systemic instability in international capital markets. Those OFCs unable or unwilling to adhere to international supervisory standards (due to weak supervisory practices and/or no cooperation and transparency) pose two serious problems. First, there are prudential concerns for the effective supervision of international financial intermediaries in order to forestall a bank collapse from putting the payments system in danger. Second, there are market integrity concerns relating to the effectiveness of international enforcement efforts in respect of illicit activity and abusive market behaviour.

There are thus substantial global welfare losses from OFCs to be set against the marginal benefits to small economies with no other legal source of high income other than perhaps tourism. These losses are composed of the loss of fiscal revenue to other jurisdictions where firms’ and individuals’ economic activities take place on the one hand, and the cover that tax evasion flows give to money laundering, narcotics funding – and now terrorist finance – on the other.

The Financial Action Task Force (OECD 2000) initially defined 35 jurisdictions as ‘non-cooperative countries or territories’ in key areas of transparency and information exchange required to meet international anti-money laundering standards for – a list which included the Bahamas, Cayman Islands, St. Kitts & Nevis, St Vincent & Grenadines, Dominica and Panama in the region as well as Israel, Lebanon, Liechtenstein, Philippines and Russia. Six, including Bermuda and the Caymans, rapidly made commitments to eliminate harmful practices by the end of 2005. In the wake of
global anti-terrorist measures after September 2001, the remaining Caribbean states and
UK dependencies\(^{16}\) in the region had signed by February 2002; embracing international
standards for transparency, exchange of information and fair tax competition (FSF,
2000). It remains to be seen, however, how effective the information exchange is in
practice, because this would mean that OFCs would lose most of their comparative
advantage.

3. INTERVENTIONS IN THE INTERNATIONAL FINANCIAL SYSTEM SINCE SEPTEMBER
2001

*Multilateral Intervention*

In October 2001, the Financial Action Task Force expanded its mandate from narcotics-
related money laundering to include terrorist financing. Its existing mandate apparently
made it particularly suitable to prevent the misuses of world financial system by
terrorists. Following this, the FATF issued a series of special recommendations to be
adopted by member states. These recommendations drew upon the content of the ‘Forty
Recommendations’ but were more closely concerned with terrorist funding. The seven
parts of the new FATF guidelines include the criminalisation of terrorist funding and
connected money laundering, followed by the seizing and confiscating of terrorist
assets.\(^{17}\) States should also increase cooperation, sharing information and assisting others
in bringing financial criminals to justice. However, relatively little thought has apparently
been given yet to implementation, with decisions instead being left up to individual
member states for the time being. The FATF has yet to develop interpretations based on
the experience of member states: effectively is still at the data gathering stage.

\(^{16}\) As well as the Channel Islands.
The FATF recommendations are intended to separate the legal and necessary actions of remittances and the donation of money to non-profit organizations on the one hand from the illegal acts of financial crime and support of terrorist activities on the other. Unlike more traditional money laundering, in which crime has already taken place before the money is transferred, the origins of terrorist financial support may be completely legal, until they enter terrorist financial channels. Informal channels such as hawala are used legally by many to transmit their remittances to their home countries, as well as providing a conduit for terrorist support. As a result, these transactions are both more difficult to track and risk impeding legal financial transfers. Since these transfers are by nature informal, there is no “paper trail” for investigators to follow. In an attempt to curtail an activity that seems unregulatable, the FATF recommendations suggest promoting alternative means for transferring money and increasing the number of documents kept on transactions. Additionally, wire transfer operators have been asked to keep additional records of transactions and to attach all information of sender and recipient at all points in the transaction. At the same time, the recommendations call upon those who conduct any transactions – including large cash operations such as gambling - to ‘know their customers’ and to attach this identification material to the transfer. The lack of this information is seen as suspicious and is liable to be reported – but the effectiveness of this measure remains to be seen.

The FATF is a monitoring, coordinating multi-lateral organization, but its means are limited to cope with its new mandate. Little public information exists on the success of its mission. Since the October 30 2001 release of the Special Principles on Terrorism, the FATF has released documents aiding states in the identification of suspicious activities. The first step in the FATF monitoring procedure involves a self-assessment questionnaire to all member states, to track their progress in implementing these new guidelines. More recently, non-member states have been invited to fill out this questionnaire also.

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17 FATF Special guidelines on Terrorism, http://www.fatf-gafi.org/SRecsTF_en.htm
18 ibid.
This questionnaire is designed not only to determine if states have been implementing the guidelines but also to provide case studies for other states to follow in their policy design. Drawing upon the results of some of the questionnaires, the FATF has produced guidance notes to help financial institutions do avoid becoming the unwitting conduit for terrorist funds.20

The G7 has made repeated statements calling for cooperation among its members and the joint determination of lists of those firms and persons whose financial transactions should be stopped. At the April meeting of G7 finance ministers, the high degree of intergovernmental cooperation was credited with substantially curtailing terrorist groups. The US Treasury Secretary announced that, “the unity with which the international community has tackled that goal in the intervening months in heartening”.21 In October 2001, G7 members were quick to accept the UN resolutions and agree to freeze assets connected to terrorism in their jurisdictions. Their joint declaration at the end of the April 20 2002 finance ministers meeting states that “as a further and positive step forward in designation of terrorist entities, the G7 finance ministers announced today the first G7 joint designation of terrorist entities and the associated freezing of assets in the G7 countries; the ministers encourage other countries to freeze these assets as well.” This cooperation does not merely extend to members of the OECD. Ministers from Saudi Arabia, Bahrain, Malaysia, the United Arab Emirates, Brazil, Russia, Kuwait, and Pakistan were invited to a post-meeting dinner to discuss measures to be taken to limit financial flows supporting terrorism. This invitation indicates the importance that G7 members, in particular the United States place on the limiting terrorist financing and the recognition that cooperation with the leading emerging market financial centres is necessary for any success.

The G7 are also taking action to increase information sharing and cooperation in broader measures to fight financial crime. While the impetus for these actions is relatively new, it

20 guidance for Financial Institutions in Detecting terrorist financing activities http://www.fatf-gafi.org/TerFinance_en.htm
21 US Treasure press communiqué, April 20 2002
draws upon previous anti-money lending and anti-drug smuggling agreements. At the G8 meeting of May 13-14 2002, measures were taken to increase cooperation across borders, particularly in electronic communications and e-commerce, in an attempt to stop terrorists from abusing the system. They also instructed a working group to study “apparent and potential links between terrorism, human smuggling, travel-document fraud, drug and firearms trafficking and money laundering.”

In November 2001, the G20 adopted an action plan to increase cooperation among states and with international institutions to adopt measures necessary to limit international terrorist funding. According to this plan, all states would ratify the existing conventions and resolutions dealing with terrorist financing; collectively they would draw up lists of offending groups so that their assets could be frozen and information would be shared to make action possible. Liaising with the FATF and other international actors, common standards limiting terrorist financing were to be implemented. Also, more developed countries promised financial support and assistance to those states that lacked the infrastructure to carry out these missions effectively.

**Unilateral Intervention**

In matters such as regulation of terrorist financing, declarations are difficult to separate from action. Most of the actions taken in the immediate aftermath of September 11 involved the creation of new bodies or restructuring of old one to meet this new threat. States pledged increased cooperation and information sharing. The greatest success can be noted in the United States and the United Kingdom (HM Treasury, 2001), the two states that have made great commitments to freezing terrorist funds. In all, most of the successes of stopping terrorist financing have arisen from these two countries. By April

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23 Ibid

2002, law enforcement officials had seized some US$100 million dollars of terrorist funds, but this seems to be a rather small sum in relation to the scale of illegal funding that is commonly supposed.

The US response to terrorist financing was probably the swiftest and most wide ranging. The October 2001 the Patriot Act includes several amendments to the bank secrecy act and new anti-money laundering measures. Within the Patriot Act, Title III is the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001. The Financial Crimes Section of the Department of the Treasury is the government agency responsible for determining policy on terrorist financing. The American Banking Association (ABA) has cooperated with this agency to introduce new practices to reduce money laundering. In February 2002, the ABA announced new procedures to reduce the threat of terrorists misusing the US banking structures, including new checks for the opening of bank accounts.

American banks led by the ABA have clearly been supportive of US government policy as detailed in the Patriot Act and its amendments. The ABA has produced resource guides to help banks increase the information gathering on their clients and to identify suspicious transactions. However, the ABA has also challenged certain aspects of the Patriot Act, claiming that new provisions for cooperation between the government and the banks might impinge upon existing agreements of ongoing information sharing. They fear that the creation of new channels might circumvent older ones and even make

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25 announced at the April G7 meeting [source].


27 ABA UNVEILS INDUSTRY RESOURCE GUIDE TO FURTHER COMBAT TERRORISM AT THE ACCOUNT-OPENING STAGE, February, 12, 2002 http://www.aba.com/Press+Room/byrne_testimony_021202.htm

information sharing more difficult, and that the time restrictions on reporting are unrealistic.

Other G7 members such as Japan were quick to abide by the UN resolutions and G7 Agreements on terrorist financing. Following the G7 meeting in Washington in October 2001, Japan set up a Task Force for Intelligence and Countermeasures against Terrorist Financing. This task force was charged with the role of “discussing and coordinating policy issues on exchange of information related to terrorist financing and countermeasures against terrorist financing” within Japan.  

The limitations on unilateral action through banking systems arise from the process of financial globalisation itself. The process of integrating world banking has led to the increased use of correspondent banks, many of them operating in or through offshore financial centres. Major international banks in developed countries have steadily reduced the amount of paper record keeping in branches and amount of skilled staff time spend monitoring clients, in order to reduce unit cots of account management where the margins are very thin. Large net worth clients are handled by ‘private banking’ where secrecy is a valued service and excessive disclosure would lead to client loss. The shift of information onto computerised systems, while reducing costs has also led to a loss of non-standard information. The same process, of course, leads to easier access to transactions records themselves, but these are extremely difficult to analyse in practice unless the target client and the nature of the transaction are known in advance.

Banking – in the traditional sense at least – no longer dominates international financial flows. In particular, banks now act as originators of funds but tend to invest these in marketed securities or lend them to other banks, often on their depositors’ behalf, so that they need not undertake the monitoring function upon which much of financial interdiction depends in principle. Capital markets themselves do not collect information on buyers or sellers of securities, even though they do of course closely monitor the

original issuers of these securities. This ‘disintermediation’ process has been extended to the relationship between developed and developing country capital markets, thus simplifying illegal funds transfers through methods ranging from traditional bearer bonds to sophisticated financial options.

**Intervention in Informal Money Transfer Networks**

Informal financial transactions systems such as hawala networks have been the subject of increased regulation and anti-money laundering declarations. While states such as the UAE have not banned hawala, it is important that they are seen to be participating in the international struggle against terrorism. From October 2001, the UAE central bank has required all moneychangers to report transactions of more than $550.\(^{30}\) In May 2002, at a two-day conference in Abu Dhabi, UAE, 300 representatives from banking and law enforcement agencies called for the application of the FATF regulations to the hawala industry.\(^{31}\) The apparent reason for holding the conference was to convince the United States and other members of international community that the UAE was taking the adverse effects of money lending seriously.

The declaration from the Abu Dhabi meeting stated, “the international community should continue to work individually and collectively to regulate the hawala system for legitimate commerce and to prevent its exploitation or misuse by criminals and others.”\(^{32}\) To this end, they should “designate competent supervisors to monitor and enforce the application of the recommendations of the Financial Action Task Force to hawala dealers and other alternative remittance providers.”\(^{33}\) The proposals to regulate hawala stems from fears that use of the system to channel money to terrorists might result in the system

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31 [source]

32 Declaration from International Conference on Hawala, May 15-16 2002

being shut down. At the international conference, the positive attributes of hawala were emphasized in addition to the fear that any attempt to eliminate informal channels would merely drive more transactions underground. On May 28, the Central Bank of the UAE announced that hawala operators in the UAE would be licensed and regulated. Pakistan has launched a scheme to convince its nationals to avoid unofficial channels. This scheme provides novel incentives, including baggage allowance and preferential treatment at airports, to those who comply. However, it is unclear what degree of success these measures might have.

4. CONCLUSIONS AND POLICY RECOMMENDATIONS

The campaign to interdict terrorist financing seems to demonstrate the value of intergovernmental cooperation. However, many measures taken recently are commitments rather than action. While it is too soon to determine how successful the adopted measures have been, success seems limited mainly to unilateral action within the United States and the United Kingdom. To ensure the wholehearted participation of other member countries of the OECD, and of leading emerging market countries, would require that they have a more effective share in decision making by international bodies. In other words, that sovereignty should be effectively pooled by the US and UK as well. To the extent that that the proposal for fiscal compliance incentives discussed below were to be implemented, this would also provide a strong economic motive for governments of poor countries to participate effectively.

34 http://www.uaeinteract.com/news

The nature of the international financial system makes limiting terrorist finances more difficult. However, even within formal institutional structures, the nature of bank secrecy makes the tracking of transactions difficult. With the growth of the Internet and the increasing impersonalisation of the banking industry, banks find it more difficult to detect suspicious transactions. For many offshore banking companies, their very comparative advantage is in high secrecy and minimal records. As a result, cooperation faces obstacles from all sides. Indeed, governments are often unwilling to share information with banks, expecting instead that banks will act as a conduit for information to the government.

By definition, attempts to exercise some form of regulatory control over hawala systems imply that these informal networks will become either increasingly formalised or they will cease to exist. Either way, any curtailment of the operations of informal MTNs is likely to have negative collateral impacts, and in particular upon marginalised users of these networks who have little or no access to formal financial services. It would not be advisable to close down these systems – even if it were possible - because they help the poor and the small enterprises that provide the bulk of employment. There are two logically preferable solutions: to oblige the formal banking system to provide these services at low cost to migrants; or to extend existing micro-credit systems – which reach these clients at the local level in developing countries – to the international level by recognising them as correspondent banks.

There is no strong economic incentive for non-bank financial intermediaries to comply in reporting dubious transactions as the probability of conviction is low and fines small. There are strong incentives for non-compliance as the sums of money involved are large and costs of monitoring are substantial- especially is high-wealth clients value secrecy highly. A solution to this problem could be to shift from the present ‘blacklist’ system administered by the US Office of Foreign Assets Control to an equivalent ‘whitelist’ system based on persons or firms registered for tax purposes (and thus monitored) in OECD countries and qualified emerging markets.
Basically, transactions with entities that are not properly registered for tax purposes would be subject to a substantial withholding tax.\footnote{At, say, 25 percent of the gross transaction – which is the retention tax levied presently within the EU for fees paid to non-residents.} This would create a strong incentive against dealing with unregulated agents. This would have three strong positive effects: first, it would make handling unregistered funds unprofitable – or at worst cost criminals a great deal to transact, reducing their liquidity and eroding their assets. Second, the process of levying the tax would provide a steady information flow on the pattern of payments not now available. Third it would mean the virtual closure of tax havens and a large increase in fiscal resources for both developed countries (to balance increased security expenditure) and developing countries to reduce social disparities. The European Community proposal for the taxation of cross-border interest payments, the ‘withholding tax directive’, is a precedent that shows that a measure of this nature is feasible (EC, 1998).

The concern of OECD members to coordinate measures against tax evasion, avoidance and competition between themselves – and the resultant pressure on offshore centres – has until now been based on concern for their own tax bases. To extend such cooperative measures towards middle-income non-OECD measures (many of whom already have observer status at the OECD) would be a logical and technically feasible step. Proposed measures to stabilise short-term financial flows in emerging markets also involve withholding taxes (Zee 1998, FitzGerald, 1999). On more general grounds Tanzi (1996a, b) has argued that the time has come for the establishment of a ‘world tax organisation’. This would not set out to impose or collect taxes (which is politically infeasible) but rather to support national authorities. Such an organisation would exercise surveillance on tax systems worldwide; resolve disputes on tax competition and exercise moral pressure on free riders; gather tax statistics and communicate best practice; and develop codes of conduct in tax administration. Supporting the interdiction of criminal funds would be yet another justification for an overdue international reform.
References


