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Combating money laundering: does implementing the Financial Action Task Force recommendations bite?¹

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Summary

This briefing note summarises research that looks at the effect of the FATF recommendations on Illicit Financial Flows (IFF), in particular the flows identified by examining trade gaps, or discrepancies between the declared or true value of goods exported and imported. The Financial Action Task Force (FATF) focuses on combatting money laundering. In February 2012, it codified its 'FATF Recommendations 2012', consisting of a framework of measures and international standards to combat money laundering and terrorist financing. Once a country agrees to follow the recommendations, it has to present its anti-money laundering framework that can be assessed by FATF.

In the research, we address a simple question: is this working? We look at a group of eight African and Middle Eastern countries that in the 2012–2020 period voluntarily agreed to implement these recommendations. The research uses a 'difference in difference' framework to test whether suspected IFF, measured through the trade gap methods, decline after the decision to implement FATF recommendations. Our results point to a reduction of the trade gap characterising tax avoidance through under-invoicing for imports and/or over-invoicing for exports. To the best of our knowledge, our research is the first to show the impact of the FATF recommendations on tax avoidance. While our results need to be seen as exploratory and treated with some caution, particularly given the limited sample of countries we studied, the findings are promising.

1 For the full research paper, see Bensassi, S and Raz, AF (2022). *Combating money laundering: does implementing the Financial Action Task Force recommendations bite?* SOC ACE Research Paper No.5. Birmingham, UK: University of Birmingham.

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Background

The Financial Action Task Force (FATF) is an intergovernmental organisation that focuses on combating money laundering and terrorist financing. Among money-laundering operations, cross-border money laundering is of particular concern for governments and international organisations, because it allows criminal organisations to grow outside their domestic base (FATF, 2006). In February 2012, the FATF codified the 'FATF Recommendations 2012', consisting of a framework of measures and international standards to combat money laundering and terrorist financing (FATF, 2012–2021). Since the initial launch, the recommendations have been updated regularly.⁵ Alongside this, the FATF also published a methodology for assessing compliance with its recommendations and the effectiveness of Anti-Money Laundering / Countering the Financing of Terrorism (AML/CFT) systems in each country. This methodology addresses two main areas: 1) the effectiveness of a country's framework in combating money laundering; and 2) technical compliance with regard to the recommendations (FATF, 2013–2021). In order to demonstrate compliance, once a country agrees to follow the recommendations, it is required to establish an anti-money laundering framework that can be assessed by FATF in line with this methodology. Failing to demonstrate compliance can result in a country being blacklisted or grey-listed. Blacklisted countries, such as Iran and

North Korea, faces heavy consequences and are cut off from the global financial system.⁶ Grey-listed countries might face difficulties when interacting with international institutions such as the International Monetary Fund (IMF) and the World Bank or some governments and the European Union (EU).⁷⁸

Hence the FATF recommendations represent one of the few coordinated defence systems against the internationalisation of organised crime and terrorist groups. This briefing note attempts to answer an essential question for policymakers, international organisations and the wider communities interested in combating money laundering: are these recommendations effective?

We suggest that because of the nature of the recommendations and the methodology to assess compliance, which increases scrutiny of financial services overall, these recommendations have the potential to curb many kinds of IFF, not only the international money laundering that is their stated target. This is in line with the FATF recommendations that include tax avoidance – a potentially large share of IFF – as predicates of money laundering (FATF 2012–2021). In 2016, following a public hearing of the European Parliament Committee of Inquiry into Money Laundering, Tax Avoidance and Tax Evasion, David Lewis, the FATF executive secretary at the time, wrote: 'Tax evasion is a predicate offence for money laundering That means that implementing the FATF standards supports effort to stop tax evasion'.

5 The recommendations were last updated in October 2021.

6 FATF (n.d.). 'Topic: High-risk and other monitored jurisdictions'. Available at: [https://www.fatf-gafi.org/publications/high-risk-and-other-monitored-jurisdictions/?hf=10&b=0&s=desc\(fatf_releasedate\)](https://www.fatf-gafi.org/publications/high-risk-and-other-monitored-jurisdictions/?hf=10&b=0&s=desc(fatf_releasedate)).

7 FATF (2022). 'Jurisdictions under Increased Monitoring'. March 2022. Available at: <https://www.fatf-gafi.org/publications/high-risk-and-other-monitored-jurisdictions/documents/increased-monitoring-march-2022.html>.

8 As an example, the European Union Directive (EU) 2015/849 Article 29 stipulates: 'Member States should at least provide for enhanced customer due diligence measures to be applied by the obliged entities when dealing with natural persons or legal entities established in high-risk third countries identified by the Commission. Reliance on third parties established in such high-risk third countries should also be prohibited. Countries not included in the list should not be automatically considered to have effective AML/CFT systems and natural persons or legal entities established in such countries should be assessed on a risk-sensitive basis'. EUR-Lex (2021). Document 32015L0849, 30 June 2021. Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32015L0849>.

The measure of the IFF

We measure IFF through what is called ‘the trade gap method’,⁹ which has been increasingly used over the last 15 years for this purpose (Ferwerda et al., 2013; Cobham et al., 2021). In essence, the method compares the flow of goods reported by the exporting country and the importing country. When there are discrepancies, researchers strongly suspect underlying illegal activities related to trade, for example tax avoidance and/or trade-based money laundering (Fisman and Wei, 2004).

A positive trade gap, which is when the value of the recorded export is above the value of the recorded import, points towards the under-valuation of import or the over-valuation of export, or both.¹⁰ The under-valuation of imports often originate in tariff avoidance; the over-valuation of exports in abuse of subsidies systems or fraud related to value added tax (VAT) exemptions. Both can be related to trade-based money laundering (TBML), a form of cross-border money laundering using trade flows to move financial assets from one country to another.¹¹

A negative trade gap, when the value of the recorded import is above the value of the recorded export, points towards the over-valuation of the import or the under-valuation of the export, or both. The over-valuation of an import can be related to abuse of subsidies systems and/or access to advantageous foreign exchange rates; the under-valuation of an export might be linked to export-tax avoidance. Both can also be related to TBML (see FATF, 2006 for case studies).

Why it is so difficult to measure Trade Based Money Laundering?

The aim of FATF is to combat money laundering defined as ‘the processing of the[se] criminal proceeds to disguise their illegal origin’.¹² In its 2006 report on TBML, the FATF recognises the difficulty of addressing trade-based money laundering and gives examples of the range of schemes criminal organisations have established to transfer illegally earned assets from one country to another (FATF, 2006). FATF’s 2020 and 2021 reports on TBML complete the 2006 report and summarise the main red flags that might alert the respective authorities to TBML (FATF, 2020; 2021).

A particular difficulty for researchers interested in measuring TBML arises from the fact that in most instances it depends on cooperation between the two parties engaged in a cross-border transaction. For example, a criminal organisation is willing to transfer ill-gotten assets from country A to country B. It is connected to an exporter in country B and an importer in country A. One method the criminal organisation can use to transfer its illicit assets out of the country is for the importer over-invoice by exaggerating the value of the goods or quantity imported. The importer will pay for the over-valued good, transferring the sum agreed to the exporter in country B. In country B, the exporter pays its supplier the actual value of the goods and then transfers the remaining funds to the criminal organisation in country A.

An essential element from the perspective of trade data is that the exporter and the importer can report to their respective customs authority coherent quantities and values, that is to say quantities and values with very little discrepancy.

⁹ Or mirror statistics methods.

¹⁰ This convention was introduced in the seminal paper of Fisman and Wei (2004). We come back to details on the calculation of the trade gaps in the section on our data.

¹¹ Other forms of international or cross-border money laundering are by using the financial system or cash couriers (FATF, 2006).

¹² FATF (n.d.). ‘What is Money Laundering?’ Available at: <https://www.fatf-gafi.org/faq/moneylaundering/>.

Unless the customs authority inspects the cargo linked to the specific transaction, this trade flow will not be revealed by the trade gap methods we use.

This is a very different case from fraud related to tax avoidance at the borders that does not require collaboration between exporters and importers but relies on bribe payments to customs agents to record erroneous quantities or values at one end of the transaction (or record nothing at all). For example, positive trade gaps, defined by a value of exports superior to the value of imports for the same goods, can arise from under-valuation of imports in order to avoid tariff payments by the importer and/or over-valuation of exported goods to benefit from VAT exemption or export subsidies. Negative trade gaps may be expected and therefore not related to fraud if they are of limited value. This is because imports are recorded cost of freight and insurance included (CIF) while exports are reported free on board (FOB). However, large negative trade gaps might translate into over-invoicing of imports, perhaps allowing importers to benefit from advantageous official exchange rates or, perhaps, under-invoicing of exports to avoid export tax.

In all these cases, there is a transfer of financial value that is not related to the real value of the exchanged goods, which can be used in connection with TBML. However, it is important to note that the trade gap method will not record every instance of TBML. This method might mostly record operations related to tax avoidance and will also capture honest mistakes related to bad reporting of data. Hence, although we shed some light on the impact of FATF recommendations on tax avoidance and TBML we cannot assert conclusively that our results apply to all sort of TBML flows.

Nonetheless, we suggest that the FATF recommendations might have an impact on the IFF captured through the trade gap method even if tax avoidance is the main motivation for the discrepancies observed. In particular, the recommendations under the section on preventive measures in the FATF recommendations (section D in the 2012 report) under the sub-heading related to customer due diligence and record keeping (sub-headings 10 and 11) correspondent banking (sub-heading 13), money or value transfer services (sub-heading 14) and wire transfer (sub-heading 15) might make financial transactions related to the observed discrepancies more suspicious (FATF 2012–2021). Consequently, we test whether the implementation of the FATF recommendations reduces trade gaps.

In practice

For this analysis, we collected data between 2014 and 2020 from eight Middle East and African countries: Botswana, Ethiopia, Ghana, Morocco, Senegal, Tunisia, Turkey, Zambia, and Zimbabwe. We compile trade gap data, as outlined by Fisman and Wei (2004), explained below, using the UN Comtrade database.¹³ We retrieve export and import data¹⁴ based on the Harmonized System (HS) 6-digit 2012 classification of goods and compute the following:

$$\text{Gap} = \text{export} - \text{import} \quad (1)$$

As shown in Fisman and Wei (2004), the trade gap calculated by equation (1) can result in either positive or negative figures, depending on the over-estimation or under-estimation made by the exporting or the importing country.

¹³ UN Comtrade Database (n.d.). Available at: <https://comtrade.un.org/>.

¹⁴ We exclude re-import and re-export as these data are far less consistent for low- and middle-income countries (Golub, 2012).