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From Russia with Love?

Some recently discovered money laundering schemes have funneled large amounts of illegal money from former soviet states through European banks. This note briefly describes the evolution of the Anti-Money Laundering (AML) regime for financial institutions, the introduction of which was concurrent with the post-soviet transition and the connected illegal flows of funds. It discusses the effectiveness of the current AML regime - and its ability to detect and seize illegal funds. The brief also highlights some of its deficiencies as well as lack of compliance with its prescriptions. It proceeds to stress that after judging the current framework insufficient, the US recently introduced whistleblower rewards for AML-infringements. Europe might want to follow their lead if it really aims at limiting money laundering.

Introduction

In recent years significant deficiencies in Anti-Money Laundering (AML) compliance have been discovered in some European banks (Spagnolo and Nyreröd, 2021). A notable example is the Danske Bank case that emerged in 2018. Some have called it the largest money laundering scandal in history: it is estimated that about $230 billion in suspicious funds went through its Estonian branch between 2007 and 2015.

In several of these cases, the sources of a large fraction of the illicit assets were Russia or other former Soviet states (Shaffer and Cassella, 2020).

Prior to the Danske revelations, several schemes have been uncovered that were aimed at laundering illicit money from former soviet states into the western financial system.

In a classic example going back to 2006, about $230 million were stolen in fraudulent tax refunds perpetrated by officials in Russia and then laundered through Moldova, Latvia and then UK shell companies and banks (Browder, 2009). Famously, the tax lawyer Sergei Magnitsky investigated the theft and testified against the fraudsters and was later put in detention for the same tax theft he was investigating. About a year after he was arrested, Magnitsky passed away after allegedly being tortured and denied medical care. This tragic episode gave rise to the Magnitsky Act, which prohibits persons believed to be involved in the theft to enter the US and access its financial system.

Commented [SS1]: Do they mean enter the US? Access sounds strange to me.

Another famous (and partly related) case is the so-called Russian Laundromat (then Global Laundromat), a scheme estimated to have funneled over $70 billion of illegal money out of Russia, through Latvia, Moldova, and then the UK (Tofilat and Negruta, 2019).

Indeed, Russia is widely considered the country with the largest estimated amount of 'dark' money hidden abroad, both as a percentage of GDP and in absolute terms (estimated around $1 trillion by Novokmet et al., 2017).

However, the origin of money laundered in the transition region is not limited to Russia. For example, it is estimated that between 2012 and 2014, about $2.9 billion from Azerbaijan were illegally laundered through UK shell companies and then European banks.

Funds from all these schemes appear to have been transacted through Danske bank (Bruun and Hjejle 2018: 33), Swedbank (Clifford Chance 2020: 123), and other European banks.

This evidence warrants some reflection on the effectiveness of the AML framework, particularly in Europe.

The Current AML Regime

The development of the global AML framework has been largely concurrent with the transition from communism and the connected illegal flows of funds.

The Financial Action Taskforce (FATF) was formed in 1989, after an initiative by the G7. FATF's mission is to develop policies to combat money laundering and blacklist countries that do not comply. The FATF issued its first recommendations in 1999 and continually updates them, most recently in FATF (2021).

These recommendations set out essential measures that countries should have in place to identify money laundering risks, including regulation on preventive measures for the financial and other sectors, powers and responsibilities for competent authorities, coordination of their actions, and the facilitation of international cooperation (FATF 2021: 7).

AML regulation requires financial institutions to know their customers and engage in due diligence to reduce the risk that they onboard criminals seeking to launder money. Information about suspicious transactions and activities should be forwarded to a national financial intelligence unit, usually the financial police. National Financial

Services Authorities (FSAs) are usually responsible for enforcing compliance with AML rules – the "preventive" side of money laundering regulation. The "repressive" criminal law or "enforcement" side of the fight against money laundering is usually enforced by the national financial police (Reuter and Truman 2004, Svedberg Helgesson and Mörth 2018).

There are certainly valid questions to be raised regarding the effectiveness of the current AML framework. While the World Bank estimates that between 2 and 5% of global GDP is laundered annually, it is also estimated that less than 1% of the proceeds of crime laundered via the financial system are currently seized by regulators and law enforcement agencies (UNODC 2011: 7).

At the same time, the framework is quite costly to comply with. There have been six EU Directives related to AML. All require legal implementation and impose new demands on banks and other covered institutions. FATF also requires that its members frequently carry out National Risk Assessments, and countries are also subject to Membership Evaluation Reports which imposes additional costs. Compliance costs for banks are estimated in the billions of dollars (Spagnolo and Nyreröd, 2021), and a whole industry surrounding "AML Compliance" has emerged. Part of these costs, not only monetary ones, end up transferred to bank customers.

From a more rigorous policy evaluation point of view, the AML regime is also problematic. There is a remarkable lack of data for assessing the effectiveness of the framework relative to its objectives (see e.g., Halliday et al. 2014, Levi 2018, Levi et al. 2018, Pol 2018, 2020).

Bank's Failures

A lack of compliance with this preventative framework has been widespread. In Sweden, for example, most large banks have been fined for various degrees of AML deficiencies. Similarly, many banks in other European countries received fines from local and US regulators (in the order of billions of dollars) for failing to comply with this framework, including HSBC, Credit Suisse, Deutsche Bank (multiple times), BNP Paribas, MagNet Bank, and Barclays Bank. Since 2016, the US has issued AML-related fines on eight occasions to banks with headquarters in European countries for an aggregate amount of $1.7 billion (mean $217 million fine; data from violationtracker.org).

In the case studies we discuss in Spagnolo and Nyreröd (2021), most forms of internal controls failed to some extent. Whereas external whistleblowing was rare or non-existent, internal whistleblowers did not manage to rectify the problems either.

Simultaneously, there were often clear red flags that should have alerted board members and executives. At Danske Bank group, for example, returns on allocated capital in the non-resident portfolio at their Estonian branch, where a substantial part of the money laundering occurred, hit 402% in 2013, compared with the 6.9% average for the whole group, a clear red flag (Schwartzkopff, 2018).

Supervisor's Failures

The extensiveness of AML non-compliance cannot only be traced to negligent banks – it also has to do with the ineffectiveness of the enforcement of AML rules by supervising authorities.

In the cases reviewed in Spagnolo and Nyreröd (2021), supervisors appeared by and large aware of at least part of the AML deficiencies. Oftentimes, banks were given warnings by regulators, yet continued to violate the same rules.

For example, both the Danish FSA and the Estonian FSA seem to have had some knowledge of the AML deficiencies at Danske Bank's subsidiary already in 2007, with little consequences.

Coordination between regulators has also been poor. The Danish FSA argues that the primary AML oversight responsibility for the Estonian branch should be the local FSA (Finanstilsynet, 2019), while the Estonian FSA retorts that European rules are not as clear and that the Danish FSA at least has some responsibility to oversee the branches of Danske Group (Finantsinspektsioon, 2019).

On September 24, 2018, the European Banking Authority (EBA) opened an investigation to assess whether the Danish and Estonian FSAs have violated any European laws. On April 16, 2019, it voted to reject an internal draft into supervisory failings that allegedly identified several shortcomings in how Danish and Estonian authorities supervised Danske bank. (Brunsden 2019). The EBA supervisory board's decision to close the investigation without adopting any findings drew criticism from a range of senior policymakers and spurred calls for its reform. The EBA has also been criticized for its reluctance to pass judgment on its members (Bjerregaard and Kirchmaier 2019: 38).

Conclusion

The limited regulatory enforcement and compliance with the current AML system are likely to only marginally increase the cost of money laundering for criminals. Policymakers should thus wonder whether the current system is delivering value for money. There could be different ways to improve it. Increased fines for non-compliance may for example induce covered entities to comply with the AML framework to a greater extent.

Moving forward, the inconsistent enforcement of AML rules has led experts and policymakers to suggest centralizing some supervision and enforcement of AML regulation at the EU level (Kirschenbaum and Véron 2018, 2020; Unger 2020; JPP 2019; EC 2020, p.8), and improving information sharing between supervisors.

We believe these measures may not be sufficient for facilitating compliance with AML, while imposing substantial enforcing costs.

One way to increase AML compliance at a relatively low cost could be introducing whistleblower reward programs, as done in the US early this year (Nyreröd and Spagnolo, 2021). These programs offer substantial monetary rewards, often in the order millions of dollars, for information on non-compliance, and have proven extremely effective in combating fraud against the government, tax evasion, and securities fraud. While national EU supervisors may not have sufficient resources or competence to manage such programs, centralized actors such as the European Commission appear able to do so. If we see more centralized supervision, together with increased resources and competence, a well-designed and properly implemented whistleblower reward program may become a highly effective way to fight money laundering in the EU.

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