

The supervisory approach to anti-money laundering: an analysis of the Joint Working Group's reflection paper

Banking Union Scrutiny



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Abstract

On August 31 2018, a Joint Working Group consisting of representatives of the European Central Bank, the European Commission and the European Supervisory Agencies published a document entitled 'Reflection paper on possible elements of a Roadmap for seamless cooperation between Anti Money Laundering and Prudential Supervisors in the European Union'. The reflection paper straightforwardly calls for additional resources to be made available to the European Banking Authority to counter money laundering. Suggestions for better cooperation and information sharing among anti-money laundering and prudential supervisors, however, risk being ineffective, as long as the underlying incentives to engage in international regulatory competition towards low enforcement of anti-money laundering standards are not addressed. To eliminate the potential for regulatory competition, anti-money laundering supervision needs to be raised to a European level.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

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Manuscript completed in November 2018

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EXECUTIVE SUMMARY

Recently a series of banks in the euro area were found to have breached anti-money laundering provisions. These include ABLV Bank in Latvia, Pilatus Bank in Malta, Versobank in Estonia, ING Bank in the Netherlands, and the branch of Danske Bank in Estonia. These cases have raised doubts about the effectiveness and current organization of bank supervision with respect to Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) in Europe. In the euro area, there are separate national supervisory authorities charged with enforcing anti-money laundering rules, while the European Central Bank conducts prudential supervision with a view to ensuring bank stability, taking into account information on banks' compliance with AML/CFT rules.

On August 31 2018, a Joint Working Group consisting of representatives of the European Central Bank, the European Commission and the European Supervisory Agencies published a document entitled 'Reflection paper on possible elements of a Roadmap for seamless cooperation between Anti Money Laundering and Prudential Supervisors in the European Union'. The reflection paper identifies a range of specific actions to be taken by the pertinent authorities to improve the practical coordination of AML/CFT supervision in the short term and beyond. This briefing paper assesses whether the recommended actions of the Joint Working Group's reflection paper live up to the objective of entrusting the EU with more effective anti-money laundering supervisory standards.

Money laundering is a profitable financial activity that can facilitate crime domestically as well as internationally. In this setting, the benefits of money laundering (higher bank profits) accrue nationally, while the costs of money laundering (more crime) are shared internationally. Regulatory competition among AML/CFT supervisors can give rise to an inadequate national enforcement of AML/CFT rules, and a reluctance to share information internationally with other bank supervisors. Prior research shows that AML/CFT standards around the world are positively related to GDP per capita, as poorer countries could be unable to adequately enforce AML/CFT standards. In the European case, AML/CFT standards in addition appear to be positively correlated with economic size, which could reflect that smaller countries lack the resources to implement high AML/CFT standards or alternatively that they are less engaged in implementing high standards. Empirical evidence that AML/CFT standards vary internationally in predictable ways on the basis of variables such as GDP per capita and economic size provides a motivation for policy initiatives in the EU to bring about a high and even compliance with international AML/CFT standards that goes beyond considering cases of AML breaches at individual banks.

The reflection paper straightforwardly calls for additional resources to be made available to the European Banking Authority to counter money laundering. Suggestions for better cooperation and information sharing among AML/CFT and prudential supervisors, however, risk being ineffective, as long as the underlying incentives to engage in international regulatory competition in AML/CFT enforcement are not addressed. To eliminate regulatory competition entirely, AML/CFT supervision needs to be raised to a European level. The reflection paper mentions the establishment of an EU body charged with AML/CFT supervision as a possible longer-term option without offering an evaluation of this possible scenario at present.

1. INTRODUCTION

Recently a series of banks in the euro area were found to have breached anti-money laundering provisions. These include ABLV Bank in Latvia, Pilatus Bank in Malta, Versobank in Estonia, ING Bank in the Netherlands, and the branch of Danske Bank in Estonia.¹ These cases have raised doubts about the effectiveness and organization of bank supervision with respect to Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) in Europe. In the euro area, there are separate national supervisory authorities charged with enforcing anti-money laundering rules, while the European Central Bank (ECB) conducts prudential supervision with a view to ensuring bank stability, taking into account information on banks' compliance with AML/CFT rules.

On August 31 2018, a Joint Working Group consisting of representatives of the European Central Bank, the European Commission and the European Supervisory Agencies (ESAs) published a document entitled 'Reflection paper on possible elements of a Roadmap for seamless cooperation between Anti Money Laundering and Prudential Supervisors in the European Union' (see ESAs and Single Supervisory Mechanism (SSM) Chairs, 2018). This reflection paper suggests that gaps in the EU's overall bank supervisory framework, in terms of the division of responsibilities and the sharing of critical information, have contributed to serious difficulties at several European banks that have breached AML rules. To remedy this situation, the reflection paper identifies a range of specific actions to be taken by the pertinent authorities to improve the practical coordination of AML supervision in the short term and beyond.

This briefing paper provides an analysis of the supervisory approach to anti-money laundering in the EU in light of the Joint Working Group's reflection paper. Section 2 characterizes money laundering as a profitable financial activity that can facilitate crime domestically as well as internationally, and it reviews the main features of the current supervisory approach to anti-money laundering in the EU with separate AML/CFT and prudential supervisors.

Section 3 analyses the incentives that national AML/CFT supervisors face with respect to AML/CFT enforcement given that in many cases a bank's customers are largely nonresident. In this setting, the benefits of money laundering (higher bank profits) accrue nationally, while the costs of money laundering (more crime) are shared internationally. Regulatory competition among AML/CFT supervisors can give rise to an inadequate national enforcement of AML/CFT rules, and a reluctance to share information internationally with other bank supervisors. Regulatory completion of this kind can be obviated by raising AML/CFT supervision to a European level.

The Financial Action Task Force (FATF) is an intergovernmental body that has formulated 40 Recommendations encompassing legal, regulatory and operational measures for combating money laundering and terrorist financing. The FATF and associated international groupings monitor member countries' progress in implementing the FATF Recommendations by way of periodic mutual evaluations of countries' AML/CFT regimes. Prior research by Yepes (2011) of the International Monetary Fund examines the determinants of the variation in the evaluation scores that countries have received in these evaluations covering the 2004-2001 period. A main finding is that compliance with international AML/CFT standards is positively related to GDP per capita, as poorer countries could lack the resources to adequately enforce AML/CFT standards.

Section 4 reviews the scores that EU member states have obtained in the FATF evaluations since 2005. We find some persistence of these scores over time, even if there is some indication that the average score has risen. Also, there is some evidence that the quality of national AML/CFT regimes is positively correlated with country size as measured by Gross Domestic Product (GDP). This could reflect that

¹ See Deslandes and Magnus (2018) for a description of these cases from an EU banking supervisory perspective.

smaller countries lack the resources to implement high AML/CFT standards or alternatively that they are less engaged in implementing high standards. Empirical evidence that AML/CFT standards vary internationally in predictable ways on the basis of variables such as GDP per capita and economic size provides a motivation for policy initiatives in the EU to bring about a high and even compliance with international AML/CFT standards that goes beyond considering cases of AML breaches at individual banks.

Section 5 assesses whether the recommended actions of the Joint Working Group's reflection paper live up to the objective of entrusting the EU with more effective anti-money laundering supervisory standards. The reflection paper straightforwardly calls for additional resources to be made available to the European Banking Authority (EBA) to counter money laundering. Suggestions for better cooperation and information sharing among AML/CFT and prudential supervisors, however, risk being ineffective, as long as the underlying incentives to engage in international regulatory competition in AML/CFT enforcement are not addressed. The reflection paper mentions the creation of an AML/CFT supervisor at a European level as a possible longer-term objective without at this point providing an evaluation of this possible outcome. Section 6 concludes.

2. THE SUPERVISORY APPROACH TO ANTI-MONEY LAUNDERING IN THE EU

The website of the European Commission describes money laundering as follows:

“Money laundering is the process by which criminal proceeds are ‘cleaned’ so that their illegal origins are hidden. It is usually associated with the types of organised crime that generate huge profits in cash, such as trafficking in drugs, weapons and human beings as well as fraud.”²

Money launderers are primarily concerned about the success of their money laundering efforts, and not by the returns on their funds as conventionally measured. As a result, banks can offer low interest rates to money launderers, and money laundering provides banks with a cheap source of funding.³ This can make money laundering a very profitable activity for banks. To illustrate, the branch of Danske bank in Estonia that attracted substantial questionable funds from nonresident customers in Eastern Europe achieved a very high return on equity before loan losses of 58% in 2010.⁴

Money laundering is illegal, as banks are implicitly taken to be accomplices in the underlying predicate crimes and to facilitate these crimes. The criminalization of money laundering, however, is a relatively recent phenomenon. Money laundering, for instance, was not an offense in the United Kingdom until 1990.⁵ At the EU level, the AML Directive of 1991 required member states to prohibit money laundering with an emphasis on drug money, and it introduced obligations for financial institutions to try to prevent money laundering by identifying their customers, keeping records, and refraining from transactions they know are suspect. Later revisions of the AML directive progressively expanded its scope. The third AML Directive of 2005, for instance, introduced terrorist finance as a major concern (see Mitsilegas and Gilmore, 2007). In July 2018, the fifth AML Directive entered into force, aiming, for instance, to bring about better information sharing among anti-money laundering and prudential supervisors.⁶

In the EU, the enforcement of AML/CFT rules as laid down in the AML Directive is entrusted to national competent authorities.⁷ In the case of international banks, host countries are responsible for AML/CFT supervision of local subsidiaries, while the home country is responsible for prudential supervision at the consolidated level which requires it to take into account information on AML/CFT compliance provided by the host country. According to EU rules, AML/CFT supervisory authorities can be different from prudential supervisory authorities. In the euro area, for instance, euro area member states have national AML/CFT supervisory authorities, while prudential supervision is entrusted to the ECB.

The ECB's task is to ensure the soundness of financial institutions to preserve financial stability. This immediately implies that the ECB is concerned with conduct risk stemming from money laundering

² See https://ec.europa.eu/home-affairs/what-we-do/policies/organized-crime-and-human-trafficking/money-laundering_en

³ Banks similarly can obtain a funding cost advantage by accepting the proceeds from tax evasion or capital flight. See Abalkin and Whalley (1999) for an account of capital flight from Russia that in part stemmed from the perceived risks of maintaining wealth in Russia.

⁴ See Bruun and Hjejle (2018, p. 80).

⁵ See Aldridge (2008).

⁶ In addition, the fifth AML directive includes measures to enhance transparency on beneficial ownership, it reinforces the framework for the assessment of high-risk third countries, and it addresses risks related to anonymous prepaid cards and virtual currencies (see European Commission, 2018b and 2018c).

⁷ At an international level, the Basel Committee (2017) provides guidelines on a sound management of risks related to money laundering and the financing of terrorism. FAFT (2014) provides guidance for a risk-based approach to enforcing AML/CFT regulations in the banking sector, while FATF (2015) formulates guidance for an effective supervision and enforcement by AML/CFT supervisors of the financial sector and law enforcement.

activities that can materialize in the form of hefty penalties imposed by law enforcement agencies. In addition, the ECB is required to take into account money laundering considerations in the execution of the following prudential supervisory tasks: the authorization of financial institutions, the assessment of acquisitions of qualifying holdings, and fit and proper tests of the management body. This implies that the ECB can withdraw a bank's authorization in case of serious AML breaches. To take AML/CFT considerations into account, the ECB relies on information from national AML/CFT supervisors on banks' compliance with anti-money laundering rules.⁸

⁸ Recent cases illustrate that enforcement actions by national AML/CFT supervisors as well as prudential supervisors can have major consequences for individual banks. On March 26, 2018, the ECB revoked the authorization of Versobank in Estonia following AML breaches. On 4 September 2018, ING agreed a settlement fee of 775 million euros with the Dutch prosecution service as it had insufficiently prevented money laundering.

3. POTENTIAL REGULATORY COMPETITION AMONG AML/CFT SUPERVISORS

Low national AML/CFT enforcement entails benefits that accrue locally, as it enables local banks to create a profitable banking sector that is based on cheap funding stemming from money laundering sources. The costs of low AML/CFT enforcement, however, are shared internationally, as money laundering facilitates crime not only domestically but also abroad, especially in the case of international banks with largely nonresident customers.⁹ National AML/CFT supervisors, however, may fail to adequately take into account the negative externalities of low AML/CFT enforcement for other countries. AML/CFT supervision at the national level could thus result in regulatory competition whereby national supervisors enforce AML/CFT standards too little from an EU perspective.¹⁰

Regulatory competition can entail that an AML/CFT supervisor from one member state is reluctant to share critical information with bank supervisors from other member states. In the case of international banks, the host-country AML/CFT supervisor, for instance, may face an incentive to withhold information about a subsidiary's money laundering activity from the home-country prudential supervisor to prevent the home supervisor from undertaking supervisory action against the money laundering activity at the local subsidiary, with possibly negative consequences for the local economy.¹¹ Along similar lines, national AML/CFT supervisors can face low incentives to report AML/CFT breaches by national banks to a supranational supervisor such as the ECB, as the ECB, taking a wider international perspective, could take more stringent supervisory action to stop the money-laundering of the national bank, including a withdrawal of the authorization to operate.

The fifth AML Directive that entered into force in July 2018 aims to take away legal barriers to an effective exchange of AML/CFT supervisory information among AML/CFT and prudential supervisors nationally and internationally. While these changes make more information exchange possible, they do not address the underlying disincentives of national AML/CFT supervisors to share information internationally. Hence, regulatory reform of this kind by itself is unlikely to entirely eliminate regulatory competition.

More radical reform through the establishment of an EU-level AML/CFT supervisor would be effective in obviating national AML/CFT regulatory competition, and it could contribute to an adequate level of AML/CFT enforcement throughout the EU.¹² Specifically, an AML/CFT supervisor at the EU level would take into account the negative international externalities of low AML/CFT enforcement, and it makes the potential conflict about AML/CFT enforcement between host-country and home-country supervisors irrelevant.¹³ Also, an EU AML/CFT supervisory body should be willing to provide adequate

⁹ In a press release of 12 September 2018 on the need for stronger anti-money laundering supervision, the European Commission mentions that inadequate supervision of the rules can create risks for the integrity and reputation of the European financial sector. See http://europa.eu/rapid/press-release_MEMO-18-5725_en.htm

¹⁰ AML/CFT supervision at the national level can also be difficult if multiple enforcement entities are involved.

¹¹ In the case of prudential supervision, both the group's supervisor (in the home country) and the subsidiary's supervisor (in the host country) are responsible, while in the case of AML/CFT supervision a territorial approach applies.

¹² AML/CFT enforcement across the EU could still be different due to differences in criminal law and sanction regimes.

¹³ See Montanaro (2016) for an account of how cross-border externalities stemming from national prudential supervision and the unavoidable conflicts of interest between home and host countries in a transnational crisis have led to the creation of the SSM with the ECB as the direct supervisor of significant institutions in the euro area from 2014. See Dell'Ariccia and Marquez (2006) for a theoretical analysis of international regulatory competition in the area of prudential supervision. Houston et al. (2012) find empirical evidence that less stringent bank prudential regulations induce more bank inflows.

information about AML breaches to the ECB, as both institutions would take a broader, international perspective.

At the euro zone level, there are economic reasons to assign both AML/CFT and prudential supervision of banks to the ECB to realize synergies in data collection and interpretation.¹⁴ Also, entrusting AML/CFT supervision to the ECB obviates the need for formal information exchanges between AML/CFT and prudential supervisors in the euro area. Even in this case, however, it makes sense to maintain some degree of independence of the two supervisory functions within the ECB organization, as the objectives of ensuring compliance with AML/CFT rules and maintaining financial stability are conceptually distinct, and potentially even opposing to the extent that profitable money laundering activities make a bank more rather than less stable.¹⁵ Separation of the two supervisory functions in, say, two silos within the ECB may be called for to ensure that an independent AML/CFT supervisor can refer money laundering cases to law enforcement agencies, without undue concern about whether any resulting fines could threaten bank stability. Strong enforcement of AML/CFT rules by law enforcement agencies in member states enabled by independent AML/CFT supervision remains important, as the threat from the ECB as the prudential supervisor to withdraw a bank's license in case of egregious AML breaches may not be credible in case of banks that are too big to fail.

¹⁴ Any synergies are likely to be limited to the supervision of the banking sector, as other sectors such as life insurance, payment institutions and asset management are not under the supervision of the ECB. Note that the Treaty (Article 127(6)) explicitly rules out tasks to be conferred upon the ECB in the field of insurance supervision. In case the synergies between AML/CFT and prudential supervision are deemed to be small, the task of AML/CFT supervision at a European level could alternatively be assigned to the EBA or to a new institution.

¹⁵ For similar reasons, there is a separation between bank supervision as part of SSM and monetary policy within the ECB.

4. COMPLIANCE WITH INTERNATIONAL AML/CFT STANDARDS IN THE EU

The FATF and associated organizations periodically review countries' compliance with the FATF recommendations promoting an effective AML/CFT regime. The scores that EU countries receive in these evaluations provide information about the variation in compliance with these recommendations across EU member states as well as about the overall trend in compliance. Section 4.1 reviews the scores that EU member states have obtained in these evaluations since 2005. Section 4.2 discusses evidence from research on the determinants of the variation in AML/CFT compliance scores internationally.

4.1 Data on compliance with AML/CFT standards in the EU

Based on the FATF Recommendations as amended in 2012, the FATF is currently conducting a fourth round of mutual evaluations.¹⁶ As of September 2018, fourth-round evaluation reports have been published for 10 EU member states.¹⁷ Table 1 presents the evaluation scores that EU countries have received. Specifically, columns 1-7 provide scores for compliance with subsets of the FATF recommendations related to particular AML/CFT policy areas. Column 4, for instance, provides the score for the strength of preventive measures, mostly taken by financial institutions, to prevent money laundering. The scores in the table are computed as the ratios of the actual grades that countries receive for the pertinent recommendations relative to the theoretical maximum grades.¹⁸ Hence, a score of 1 means maximum compliance. In column 4, Denmark, for instance, receives a score of 0.53 for the 15 recommendations that relate to preventive measures, which is the lowest score for any country in the table. Column 8 represents the score for the overall set of 40 AML/CFT recommendations. Denmark has the lowest overall score of 0.54, while Spain obtains the highest score of 0.88.

Table 1: Fourth-round mutual evaluations of compliance with FATF recommendations in the EU

Country	Year	Policies and coordination	Money laundering and confiscation	Terrorist financing and financing of proliferation	Preventive measures	Transparency of beneficial ownership	Powers and responsibilities of competent authorities	International cooperation	Overall AML/CFT
		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Austria	2017	0.67	0.83	0.5	0.91	0.33	0.77	0.73	0.77
Belgium	2018	1	1	0.58	0.82	0.67	0.90	0.73	0.82
Denmark	2017	0.33	0.67	0.50	0.53	0.33	0.57	0.67	0.54
Hungary	2018	0.67	0.83	0.50	0.67	0.50	0.63	0.67	0.64
Ireland	2017	0.67	1	0.42	0.56	0.50	0.63	0.87	0.63
Italy	2016	0.67	0.83	0.67	0.71	0.67	0.70	0.80	0.72
Portugal	2017	0.67	0.83	0.75	0.67	0.33	0.77	0.87	0.72
Slovenia	2017	0.5	0.67	0.33	0.71	0.67	0.73	0.67	0.66
Spain	2018	0.83	0.83	0.58	0.93	0.67	0.93	1	0.88
Sweden	2018	0.83	0.67	0.50	0.87	0.67	0.67	0.87	0.76
Average		0.68	0.82	0.53	0.74	0.53	0.73	0.79	0.71

¹⁶ See FATF (2013) for the methodology that is used in the mutual evaluations.

¹⁷ Alternative information on whether EU member states have appropriately implemented the 4th AML directive is available from the European Commission's infringement procedure. According to a press release of 19 July 2018, the European Commission has referred Greece, Ireland and Romania to the Court of Justice for not implementing pertinent anti-money laundering rules. See http://europa.eu/rapid/press-release_IP-18-4491_en.htm

¹⁸ The evaluation reports indicate whether a country is compliant, largely compliant, partially compliant, or non-compliant for each recommendation. These ratings are scored as 1, 0.66, 0.33 and 0 in this paper, respectively.

Scores are scaled so that a score of 1 is the maximum score. Year is year of the report or in some cases of an update. Data are as of 24 September 2018. Source: FATF. See <http://www.fatf-gafi.org/media/fatf/documents/4th-Round-Ratings.pdf>

As fourth-round evaluation results are available for only 10 EU member states, it is interesting to examine the evaluation results from the prior third round as well. These results are relatively old as they reflect the period 2005-2010, but they are available for all 28 EU member states. Table 2 provides the overall third-round AML/CFT score for EU countries. Among the 10 EU member states that are common to Tables 1 and 2, Denmark obtains the lowest score of 0.5. The data of Tables 1 and 2 together imply some persistence in countries' compliance with the FATF's anti-money laundering recommendations, reflected in a positive correlation coefficient of the overall scores for the 10 countries represented in both Tables 1 and 2 of 0.25. This correlation estimate is not statistically significant at conventional significance levels, and hence there is no strong statistical relation between the two score variables. Persistence over time per se is undesirable, as it suggests that the mutual evaluation process has failed to bring about a common high anti-money laundering standard in the EU. However, the average AML/CFT score for the 10 EU countries that are common to Tables 1 and 2 has increased from 0.63 in the third round to 0.71 in the fourth round, which is consistent with a secular increase in anti-money laundering standards in the EU.

Table 2: Third-round mutual evaluations of compliance with FATF recommendations in the EU

Country	Year	Overall AML/CFT
Austria	2008	0.54
Belgium	2005	0.76
Bulgaria	2007	0.66
Croatia	2006	0.39
Cyprus	2005	0.71
Czech Republic	2005	0.51
Denmark	2006	0.50
Estonia	2008	0.63
Finland	2007	0.50
France	2010	0.65
Germany	2009	0.53
Greece	2006	0.35
Hungary	2010	0.73
Ireland	2005	0.60
Italy	2005	0.63
Latvia	2006	0.58
Lithuania	2006	0.61
Luxembourg	2009	0.35
Malta	2005	0.69
Netherlands	2010	0.56
Poland	2006	0.44
Portugal	2006	0.67
Romania	2007	0.54
Slovakia	2005	0.36
Slovenia	2005	0.72
Spain	2005	0.64
Sweden	2005	0.55
United Kingdom	2006	0.72
Average		0.57

Scores reflect 40 recommendations on AML and the special 9 recommendations on CFT and they are scaled so that a score of 1 is the maximum score. Year is year of evaluation. Data source: Yepes (2011, Table 2).

4.2 The determinants of national compliance with AML/CFT standards

Yepes (2011) provides an empirical analysis of the determinants of the overall AML/CFT score that countries achieved in the third-round mutual evaluations during the 2004-2011 period. The sample includes 161 countries. The overall AML/CFT score is shown to be positively related to GDP per capita, as a lower level of economic development could reduce countries' ability to implement AML/CFT standards. Furthermore, Yepes (2011) finds that the overall AML/CFT score is positively correlated with

indices of regulatory quality and control of corruption, which suggests that AML/CFT compliance is a reflection of overall national policy quality as determined outside the area of AML/CFT supervision.

A potential determinant of anti-money laundering standards, which is not considered by Yepes (2011), is the size of the national economy. The notion that economic size could matter is motivated by recent EU experience, which shows that several relatively small countries, including Estonia, Latvia, the Netherlands, and Malta, have experienced money laundering problems in their banking sectors. To explore the role of size, we can calculate the correlation coefficient between the overall AML/CFT score and average real GDP per country over the 2008-2010 period for the 28 EU countries in Table 2. This correlation coefficient is found to be positive at 0.16, but it is not statistically significant, which implies that there is no strong statistical relation between these two variables.¹⁹ Going beyond the overall AML/CFT score, we also estimate correlations between AML/CFT scores for subcategories of recommendations (not reflected in Table 2) and economic size. Here we find a positive correlation between compliance with recommendations addressing the adequacy of a country's legal framework with respect to AML/CFT and GDP of 0.34 that is significant at 10 percent, and a positive correlation between compliance with recommendations related to preventing money laundering through the informal sector and GDP of 0.49 that is significant at 5 percent.²⁰ In these instances, the statistical significance of the correlations between the two different sub-indices of EU countries' compliance with international AML/CFT standards and GDP implies that the estimated correlations are statistically meaningful, and not likely to have resulted from mere chance.

The available data for EU countries are too limited to prove or disprove any causal relation between economic size and compliance with international AML/CFT recommendations. All the same, it is interesting to consider what could explain this relationship. Possibly, it reflects that smaller countries lack the resources to adequately enforce AML/CFT standards, which would be consistent with the positive relation between GDP per capita and AML/CFT standards found by Yepes (2011). Alternatively, the apparent relation between economic size and AML/CFT standards could reflect that smaller countries face greater incentives to maintain relatively low standards so as to attract additional deposits from nonresidents, without the concomitant disadvantage of facilitating substantial domestic illegal activities. This second explanation would be consistent with the existence of international regulatory competition in the area of AML/CFT standards.

Overall, the empirical evidence of Yepes (2011) and in this section suggests that AML/CFT standards vary internationally in predictable ways on the basis of variables such as GDP per capita, indices of overall national policy quality, and economic size. Evidence of this kind provides a reason for additional policy initiatives in the EU to bring about a high and even compliance with international AML/CFT standards, as proposed or mentioned in the reflection paper, that goes beyond considering cases of AML breaches at individual banks.

¹⁹ Similarly, the correlation coefficient between AML/CFT scores and GDP in 2017 for the 10 countries in Table 1 is positive at 0.44 and statistically insignificant. The availability of data for only 10 member states severely hampers the estimation of this correlation.

²⁰ Correlations between scores for other subcategories of recommendations (relating to institutional measures, preventive measures for financial institutions, preventive measures for designated non-financial businesses and professions, entity transparency, and international cooperation) and country economic size are statistically insignificant. See Yepes (2011, Table 1) for definitions of the various subcategories of recommendations.

5. AN ASSESSMENT OF ACTIONS PROPOSED IN THE REFLECTION PAPER

On August 31, 2018 a Joint Working Group consisting of representative of the ECB, the European Commission and the ESAs issued a document entitled 'Reflection paper on possible elements of a Roadmap for seamless cooperation between Anti Money Laundering and Prudential Supervisors in the European Union'. The reflection paper asserts that recent money laundering experiences have exposed shortcomings with respect to cooperation and information sharing, both at the domestic level and internationally. In its problem definition, the reflection paper paints a picture of imprecise prudential rules and no articulation of the interaction between prudential and AML supervisory frameworks, relatively less developed frameworks for cooperation among AML/CFT supervisors, and insufficient resources directed towards the ESAs' role with respect to AML/CFT.

To address these deficiencies, the reflection paper identifies a range of actions to be taken by prudential supervisors, actions to be taken by AML supervisors, actions that could enhance the effectiveness, powers and governance of the ESAs, and possible longer-term options for reform, including a possible centralization of AML supervision via an existing or a new Union body. To assess the adequacy of these proposals, three questions can be asked:

- Do the proposals make more adequate cooperation and information sharing possible?
- Do the proposals sufficiently improve incentives to enforce high AML/CFT supervisory standards?
- Do the proposals solve the problem of inadequate resources for effective AML/CFT supervision?

These three questions are addressed in turn.

Do the proposals make more adequate cooperation and information sharing possible?

The reflection paper makes suggestions for prudential supervisors to better incorporate AML/CFT considerations. For instance, prudential supervisors are to provide further clarification of supervisory aspects related to the withdrawal of authorisation. Also, there are suggestions to improve the cooperation between prudential supervisors, AML supervisors and Financial Intelligence Units. Specifically, the ECB is called upon to continue to work towards concluding a multilateral Memorandum of Understanding (MoU) with all relevant national AML/CFT authorities to facilitate information exchange. Actions of this kind are useful, and they potentially provide for better prudential and AML/CFT supervision, following better cooperation and information sharing among AML/CFT and prudential supervisors.

Do the proposals sufficiently improve incentives to enforce high AML/CFT supervisory standards?

While new protocols for supervisory cooperation and information exchange are potentially useful, they do not obviate the underlying incentives for AML/CFT supervisors to err on the side of low AML/CFT enforcement and to potentially withhold critical information from other bank supervisors. Thus, it is questionable whether agreements of this kind will suffice to rule out regulatory competition regarding AML/CFT enforcement in the EU.

Recognizing that national AML/CFT enforcement can be inadequate, the reflection paper calls for the EBA to be able to request national supervisors to investigate cases of alleged money laundering, and in case of a clear lack of compliance by national authorities, to be able to adopt enforcement decisions directly addressed to financial sector operators. Increased powers along these lines, however, are not likely to be exercised frequently, and hence may only have a limited disciplining effect on national AML/CFT supervisors towards enforcing adequate AML/CFT standards.

The reflection paper also calls for the EBA to perform additional tasks such as undertaking stringent reviews of the activities of AML/CFT supervisory agencies, and to set up a Union-wide centre of

expertise or “hub” to collect and disseminate AML/CFT information. Additional tasks for the EBA along these lines should potentially have a positive effect in bringing about a better and more even AML/CFT supervision within the EU.

Enhanced powers and tasks of the EBA by themselves, however, could fail to bring about an adequate enforcement of AML/CFT rules, as even in the current setting the EBA already has considerable powers to bring about a convergence of AML/CFT supervision, for example through the issuance of guidelines, preparation of draft regulatory technical standards and the investigation of specific cases of breaches of EU AML law. These current powers apparently have not prevented money laundering scandals from occurring in the EU in the recent past. To ensure high-quality AML/CFT supervision and to entirely eliminate the potential for regulatory competition in this area, the establishment of a new EU body charged with AML/CFT supervision would be the best approach. To warrant that such an EU body enforces the same rules across member states, it would be useful to turn the 5th AML Directive into a Regulation. The reflection paper mentions the establishment of a European body to enforce AML rules as a possible longer-term objective to be considered at a future point.

Do the proposals solve the problem of inadequate resources for effective AML/CFT supervision?

The reflection paper correctly identifies additional funding for the EBA's AML task as a key priority. In line with this, the European Commission (2018a, p. 261) proposes that in the future EBA financing will rely on the general budget of the EU as well as on annual contributions from the entities within the remit of the authority. The need for additional funding for AML/CFT enforcement no doubt reflects that banks use increasingly complex analytical tools to assess money laundering risks (see Breslow et al., 2017), and that high-quality staff are necessary to evaluate these tools. Currently most costs related to AML/CFT enforcement are incurred by national AML/CFT supervisors. The reflection paper, however, does not mention the need to ensure that national AML/CFT supervisors are also adequately funded and staffed.²¹ Substantial additional funds at the EU level will be required, if at some point AML/CFT supervision in the EU is transferred to an EU body.

²¹ Eurostat (2013, Table 8) provides information on the number of full time staff employed by Financial Intelligence Units over the 2005-2010 period. Italy is shown to have the highest number of staff of 104 among EU member states in 2010.

6. CONCLUSIONS

A series of breaches of AML rules at European banks have raised doubts about the effectiveness of bank supervision in the EU. Potentially, the apparent ineffectiveness reflects the fragmentation of supervision among national AML/CFT supervisors and, in the case of the euro area, supranational prudential supervision by the ECB. In this setting, regulatory competition among AML/CFT supervisors can give rise to an inadequate national enforcement of AML/CFT rules, and a reluctance of AML/CFT supervisors to share compliance information internationally. To obviate regulatory competition entirely, it is necessary to raise AML/CFT enforcement to a European level.

The FATF and associated international groupings monitor member countries' progress in implementing the FATF Recommendations by way of periodic mutual evaluations of countries' AML/CFT regimes. Prior research by Yepes (2011) of the International Monetary Fund examines the determinants of the variation in the evaluation scores that countries have received in these evaluations covering the 2004-2001 period. A main finding is that compliance with international AML/CFT standards is positively related to GDP per capita, as poorer countries could lack the resources to adequately enforce AML/CFT standards. In the European case, AML/CFT standards in addition appear to be positively correlated with economic size as measured by GDP. This could reflect that smaller countries lack the resources to implement high standards or alternatively that they are less engaged in implementing high standards. Empirical evidence that AML/CFT standards vary internationally in predictable ways on the basis of variables such as GDP per capita and economic size provides a motivation for policy initiatives in the EU to bring about a high and even compliance with international AML/CFT standards that goes beyond considering cases of AML breaches at individual banks.

On August 31 2018, a Joint Working Group consisting of representatives of the ECB, the European Commission, and the ESAs published a document entitled 'Reflection paper on possible elements of a Roadmap for seamless cooperation between Anti Money Laundering and Prudential Supervisors in the European Union'. This reflection paper straightforwardly calls for additional resources for the EBA to counter money laundering. In addition, the reflection paper makes several proposals to bring about more cooperation and better information sharing among national and international supervisory authorities. Initiatives along these lines, however, risk being ineffective as long as the underlying incentives facing AML/CFT supervisors to engage in regulatory competition are not addressed.

Two sample questions on potential cooperation between anti-money laundering and prudential supervisors in the EU:

Q1: The reflection paper calls on the ECB to conclude a multilateral MoU regarding information sharing with all relevant AML/CFT authorities by 10 January 2019, in line with AMLD5. Will the conclusion of such a MoU be sufficient to guarantee that the ECB will receive the AML/CFT supervisory information that it needs?

[The issue is whether concluding information sharing protocols with national AML/CFT supervisors will be enough to overcome institutional inertia, if any, in generating and sharing information.]

Q2: As a distinct possibility, AML/CFT supervision can be elevated to a European level. If this were to be done, and abstracting from current mandates, is there a case to assign the AML/CFT supervisory task for banks to the ECB in order to realize synergies in supervisory data collection and analysis?

[The issue is whether synergies in the execution of AML/CFT and prudential supervision are strong enough to warrant putting the two kinds of supervision under one roof, although the objectives of enforcing AML/CFT rules and maintaining bank soundness are conceptually distinct.]

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This document was provided by the Economic Governance Support Unit at the request of the ECON Committee

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PE 624.424

Print ISBN 978-92-846-4275-5 | doi:10.2861/87572 | QA-05-18-042-EN-C

PDF ISBN 978-92-846-4274-8 | doi:10.2861/754764 | QA-05-18-042-EN-N