

**FOR
AGENDA**

SM/01/328

November 6, 2001

To: Members of the Executive Board

From: The Secretary

Subject: **Intensified Fund Involvement in Anti-Money Laundering Work and
Combating the Financing of Terrorism**

Attached for consideration by the Executive Directors is a paper, on intensified Fund involvement in anti-money laundering work and combating the financing of terrorism, prepared by a Task Force under Mr. Aninat and including representatives from the Legal, Monetary and Exchange Affairs, and Policy Development and Review Departments. Issues for discussion appear on pages 20 and 21. This subject is tentatively scheduled for discussion on Monday, November 12, 2001. Staff proposes that the report be made available to the public.

Questions may be referred to Mr. H. Evans (ext. 34918), Mr. Hardy (ext. 38490), Mr. Gajdeczka (ext. 37124), and Mr. R. Gordon (ext. 34103).

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INTERNATIONAL MONETARY FUND

Intensified Fund Involvement in Anti-Money Laundering Work and Combating the Financing of Terrorism

Prepared by a Task Force under Deputy Managing Director, Mr. Aninat and with membership of the Legal, Monetary and Exchange Affairs, and Policy Development and Review Departments

In Consultation with Other Departments and the World Bank

November 5, 2001

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I. INTRODUCTION

1. **Money laundering and the financing of terrorism are issues that affect countries at every stage of development, and involve both onshore and offshore financial centers.** Recent events have demonstrated all too clearly that terrorism can not only imperil the peace of nations, but also have far-reaching negative consequences for global economic growth and financial stability. These events and their aftermath have therefore prompted a reexamination at national and international levels of mechanisms for the promotion and enforcement of laws against both money laundering and finance for terrorism.¹ In these circumstances the Fund too needs to reconsider its contribution to these international efforts. The Fund's mandate and expertise means that its involvement must concentrate on those areas that relate to the integrity and stability of the international financial system. While the primary responsibility for combating money laundering and the financing of terrorism rests with the supervisory authorities and other relevant institutions of individual countries, the Fund can play a facilitating role within its mandate and expertise. The Fund's contribution should also be complementary to the new undertakings of the Financial Action Task Force on Money Laundering (FATF), which remains in the lead on these issues, and should be closely coordinated with other standard-setters and with the World Bank.

2. **This report summarizes the Fund's current policies and activities in anti-money laundering (AML) (Section II), presents the principal considerations and objectives in determining an approach to intensified involvement in AML and combating the financing of terrorism (Section III), outlines the Fund's expertise and mandate in this area and cooperation with other organizations (Section IV), and proposes a set of measures for consideration by the Fund Board (Section V).**² The measures are designed to build on the Fund's strengths as an international institution, without going beyond the Fund's mandate. These measures should be regarded as an immediate response to changed circumstances, and this response would evolve in due course as experience is gained. Adoption of the measures would require additional resources; a preliminary estimate of the needs is contained in Section VI, and a summary of the issues and suggested measures is contained in Section V. A number of issues are proposed for consideration by the Board (Section VII). Annexes contain additional information and background material on terrorism financing, FATF recommendations, related legal and institutional issues, and assessment methodologies.

¹ International efforts to combat terrorism and terrorism financing are summarized in Annex I.

² Many of the measures involve joint work with the World Bank. The Bank's role will be defined by their senior management and Board.

II. THE BOARD DECISIONS OF APRIL 2001 AND FOLLOW-UP

A. The Board Decision on Enhancing Contributions to Combating Money Laundering

3. **The Executive Board met on April 13, 2001 to discuss an enhanced role for the Fund in the area of anti-money laundering**, and agreed that the Fund should enhance its contribution to international efforts to counter money laundering within its core mandate, confirming that it would not be appropriate for the Fund to become involved in law enforcement activities.³ In particular, it was agreed to:

- Intensify its focus on AML elements in all relevant supervisory principles;
- work more closely with major international AML groups;
- increase the provision of technical assistance;
- include AML concerns in Fund surveillance and other operational activities when macroeconomic relevant; and
- undertake additional studies and publicize the importance of countries acting to protect themselves against money laundering.

4. **Directors generally agreed that the FATF 40 Recommendations (FATF 40) should be recognized as the appropriate standard for combating money laundering, and that work should go forward to help adapt the standard assessment process with the view to preparing *Reports on Observance of Standards and Codes (ROSC)*.** Following the development of an appropriate methodology and an assessment procedure for the FATF Standard that would be uniform, cooperative, and voluntary, the FATF could be invited to participate in the preparation of a ROSC module on money laundering. The Board invited staff to discuss these principles with the FATF, as well as to contribute to the ongoing revision of the FATF 40 Recommendations. Most Directors felt at that time that the Fund should cover only those issues in the FATF 40 Recommendations that deal with financial regulation and supervision, and that responsibility for assessing legal/crime enforcement should be left to others.

Implementation of the April 2001 Board Decision⁴

- **Staff of the Fund and Bank has prepared an AML Methodology Document based on those financial sector supervisory standards relating to preventing abuse of the financial system by criminals.**⁵ The document assesses the AML

³ See BUFF/01/54, SM/01/103, and SM/01/46.

⁴ See also SM/01/258 "Anti-Money Laundering: Enhanced Contribution by the Fund."

⁵ Annex II discusses the scope of the current Fund-Bank AML Methodology Document and its relationship to the FATF 40 and other financial system standards. The principal standards are from the Basel Committee on Banking Supervision (notably principle 15), the

elements present within the financial sector supervisory and regulatory framework to ensure that adequate controls and procedures are in place to prevent abuse of the financial system by criminals. These elements include requirements for due diligence reviews on those who control or use regulated financial intermediaries, which includes both fitness tests for owners/managers and know-your-customer rules, and these elements overlap with about 19 of the FATF 40 Recommendations. Not included within the Fund-Bank methodology document—but included in the FATF 40 Recommendations—is an assessment of law enforcement elements such as mechanisms for freezing, seizing, and confiscating proceeds of crime; methods for investigating and prosecuting money-laundering crime; and related international cooperation.⁶

- **The AML Methodology Document is being piloted, with the authorities' agreement, as part of the Luxembourg, Switzerland, Sweden and the Philippines FSAPs.** Summary assessments in the FSSAs would be reported to the Board, and may be published with the consent of the member. OFC assessments can also be distributed to the Board, and made public, with the consent of the requesting jurisdiction, and approval of management.
- **Fund and Bank staff is working closely with the FATF to revise the FATF 40 Recommendations and to adapt the FATF 40 Recommendations to the ROSC process.** In particular, Fund staff are contributing to the development of the associated assessment methodology document, consistent with the approach adopted by the two Boards for standards assessment and preparation of ROSCs.⁷ This ROSC module would cover not only AML supervisory principles, but also the broader legal, law enforcement and institutional framework of AML regimes, and extend beyond the regulated financial sector. FATF intends to complete this work and to prepare draft modalities for AML standard assessment and ROSC preparation, which could be considered by the Fund and Bank Executive Boards in 2002. If outstanding issues regarding FATF's use of various standards can be resolved, FATF (and regional FATF-like bodies) could begin making assessments later in 2002.
- **Technical assistance in the AML area has focused on financial supervisory systems, but in many instances has also included both the unsupervised sector**

International Organization of Securities Commissioners (IOSCO), and the International Association of Insurance Supervisors (IAIS). The detailed methodologies for assessing these standards contain AML elements that overlap with almost half the FATF 40 Recommendations.

⁶ International cooperation in this context relates to the interaction between governments to further law enforcement, for example, in freezing and seizing the proceeds from crime, or in gathering evidence or otherwise investigate crimes.

⁷ Annex III discusses in more detail the FATF organization, the FATF 40 Recommendations, and the FATF approach, and Annex IV discusses the ROSC process.

and legal and institutional framework for AML regimes. Technical assistance has extended beyond the regulated financial sector: AML laws have been reviewed in five cases, and intensive technical assistance is being provided to seven members of the Pacific Islands Forum to improve the legal and institutional framework for AML, including advice on the creation of a regional Financial Intelligence Unit (FIU; see Annex V and SM/01/46, Annex VIII).

III. CONSIDERATIONS IN DETERMINING MEASURES FOR INTENSIFIED INVOLVEMENT

5. **The events of September 11 has brought to the fore the questions of whether and how the Fund could extent its activities to prevent the use of financial systems for terrorist financing.** At a general level, one approach would be to extend the Fund's current AML efforts, focused on financial regulation supervision, just to incorporate areas germane to countering terrorism financing. An alternative would be to expand the Fund's role to include also the legal and institutional issues and, when relevant, the unsupervised financial sector that impact on the effectiveness of financial sector policies, including financial supervision, and that are germane to AML and anti-terrorist financing issues. (Law enforcement issues would always be left to others, in line with the April Board decision.) The second approach would respond to the great importance that the international community now attaches to the problems of money laundering and terrorist financing. However, complex questions arise concerning consistency with the Fund's mandate and possible "mission creep," as well as the division of labor amongst international bodies, particularly FATF. Questions also arise as to where to draw the line between activities related to financial supervision and legal and institutional aspects of supervision and financial sector policy generally, and law enforcement. These issues need to be reviewed in formulating effective and suitable measures for the Fund's enhanced involvement.

6. **Like money laundering, the financing of terrorism can involve both domestic and international financial systems. Both crimes are varieties of financial abuse that can compromise the integrity of the national and international financial system.** As such they must be of concern to the Fund. However, in substance terrorist finance is an issue distinct from money laundering because it involves the processing of funds, often from legitimate origins, to be used for future crimes rather than the processing of criminal proceeds to disguise their illegitimate origin (see Annex I), although many of the measures to combat each are closely related.⁸ Effective coverage and implementation of these measures raises a host of issues relating to information exchange among supervisory and other authorities, the scope of financial policies including supervisory principles, the role of both supervised and unsupervised institutions, and the related legal and institutional framework..

A. Information Exchange and International Cooperation

7. **To be effective, financial supervisors and law enforcement need access to a broad range of information with respect to financial activities and transactions.** Without

⁸ Because the crime may not yet have been committed, and for other reasons, the financing of terrorism may in some instances be harder to detect than money laundering.

such information, neither money laundering nor terrorism finance can effectively be identified nor appropriate countermeasures be applied. However, critical information gaps occur both at the national level (financial intermediaries do not convey information to authorities, authorities do not share information among themselves), and at the international level (authorities do not share information across borders). Because money laundering and terrorism often involve many jurisdictions, the failure to share information creates significant negative cross-border externalities that compromise the fight against predicate crime and terrorism.

8. The costliness of information gaps has two important implications. First, a concerted effort is needed to combat money laundering and terrorist finance. No country can resolve this issue alone. Second, the information gaps that lead to the negative externality need to be tackled through institution building at the national levels and through cooperative arrangements to foster the exchange of information at all appropriate levels.

9. Money laundering and financing for terrorism are complex phenomena, which cut across several quite separate dimensions (e.g., law enforcement, financial supervision, corporate vehicles, etc.). This complexity implies that no single agency can be expected to resolve the problem independently; multiple actors at the national and international levels must contribute.

10. **All of this calls for a disciplined and collaborative approach.** In this strategic vision every partner engaged in the global fight against money laundering and the financing of terrorism must concentrate on a set of actions which respect the expertise, scope, and mandate of the other involved institutions.⁹ This approach makes best use of the limited resources at hand.

B. Financial Policies, Supervisory Principles, and Measures to Combat Terrorism Finance

11. **Because the April Board meeting took place before the events of September 11, there was no discussion of financing of terrorism.** As noted above, most Directors felt that the Fund's contribution to AML efforts should cover financial regulation and supervision. There were at that time no financial supervisory principles specifically directed to preventing the use of the regulated financial sector for financing terrorism. However, since September 11 there have been two major relevant multilateral developments.

12. **On September 28, the UN Security Council adopted Resolution 1373, which requires that all member states of the UN prevent and suppress the financing of terrorism, including confiscating terrorist assets.** The Resolution does not define terrorism, but the UN Security Council will identify, on a case-by-case basis, specific persons or groups as terrorists or terrorist supporters (a number have already been so identified). A

⁹ Indeed, a comparison of the work agendas of the Fund, World Bank, FATF, and other institutions suggests that ample space for institutional cooperation exists.

UN Security Council Committee has been appointed, chaired by the United Kingdom, to report within 90 days on compliance with the Resolution.

13. **On October 29 and 30 the FATF, meeting in an extraordinary plenary, adopted eight new recommendations on terrorist finance**, a number of which have relevance for financial supervision. Briefly, these new recommendations include:¹⁰

1. take steps to ratify and implement relevant United Nations instruments,
2. criminalize the financing of terrorism and terrorist organizations,
3. freeze and confiscate terrorist assets,
4. report suspicious transactions linked to terrorism,
5. provide assistance to other countries' terrorist financing investigations,
6. impose anti-money laundering requirements on alternative remittance systems,
7. strengthen customer identification measures for wire transfers, and
8. ensure that entities, in particular nonprofit organizations, cannot be misused to finance terrorism.

14. **The FATF will develop additional guidance for financial institutions** on the techniques and mechanisms used by terrorists to receive and launder their funds. The FATF has requested that all countries undertake an immediate self-assessment against the new recommendations, which information could be used to assist the Security Council in evaluating compliance with Resolution 1373.

Regulated financial institutions

15. **Recommendations 4, 6, and 7 in particular are directly related to supervision of financial institutions** (application of customer due diligence, suspicious or unusual transaction reporting, standardizing information to be collected on wire transfers, and the extension of some form of supervision to bodies and persons that engage in financial transfers). The Basle Committee, IOSCO, and IAIS are expected to consider related supervisory principles in the near future. The application of "know your customer" (KYC) principles allows financial institutions more effectively to conduct customer due diligence. Therefore, they help an institution determine if the potential or actual customer (or beneficiary), or the maker or recipient of assets transfers, is a person identified as a terrorist. This allows financial institutions to implement orders to freeze assets and to record of customer information relating to asset transfers. However, when the origin of the funds is legitimate and where no crime has yet been committed, KYC rules are relatively unhelpful in identifying as potential terrorists persons not already classified as such by law enforcement

¹⁰ Annex I includes the full text of the new recommendations.

agencies. However, additional research into patterns of transactions that might suggest terrorist finance is currently being undertaken by the FATF and others.

Unsupervised financial intermediaries and other organizations

16. **As with money laundering, terrorist organizations are suspected of making extensive use of financial intermediaries that are not normally subject to prudential supervision**, such as wire remittance services and informal banking systems (including hawala systems). These unregulated intermediaries also facilitate money laundering or other financial transactions associated with criminal activity. The associated FATF recommendation proposes extension of anti-money laundering measures to these different intermediaries; further guidance in this area from the FATF and from the financial institution supervisory bodies is expected. However, ensuring compliance by these intermediaries, especially with respect to informal banking or remittance systems, is expected to be difficult. To the extent that prudential supervisory principles are not extended to these intermediaries, other bodies, including possibly FIUs, will have to play the lead administrative roles.

17. **These informal institutions exist largely to fill the “gaps” created by inadequate formal financial system.** These inadequacies may arise from the slow development of institutions and high costs, which in turn may often be caused by regulatory constraints and other government policies. Hence, an important element in combating the abuse of informal financial intermediaries is the promotion of sound and efficient formal institutions.

18. **Nonfinancial intermediaries that do not regularly engage in financial transactions on behalf of customers are also suspected of playing important roles in financing terrorism and in money laundering.** These bodies include for-profit companies and nonprofit organizations (typically organized as trusts or foundations). In particular, nonprofit bodies have been suspected of either wittingly or unwittingly serving as a vehicle for financing terrorism. While not subject to prudential supervision, such organizations are typically required to fulfill certain “fit and proper” tests with respect to ownership and control, and are often required to file audited financial statements with relevant government authorities. In addition, many jurisdictions subject nonprofit organizations to greater scrutiny to ensure that they do not mislead the public when soliciting donations and, where relevant, are abiding by the terms of a tax exemption. While the FATF recommendation is not specific, it suggests that heightened scrutiny in the form of fit and proper tests, audited accounts, and supervision of the not-for-profit sector should be encouraged. As is the case with unsupervised financial intermediaries, bodies other than financial supervisory regulators, including possibly FIUs, could play important roles.

19. **In order to ensure effective coverage of terrorism finance, the Fund’s work could be extended to include, on a case-by-case basis, certain nonfinancial bodies that might play a role in money laundering or terrorism finance.** Some of these issues are

already being addressed by Fund staff in the context of its work on OFCs, when for example the regulation of company and trust service providers are typically discussed.¹¹

C. National and International Systems for Information Sharing

20. **The scope of national and international cooperation and information sharing on financial transactions has two distinct dimensions:** the first deals with cooperation and information exchange arrangements for supervisory or regulatory purposes; the second is information exchange to facilitate criminal or civil law enforcement matter (e.g., money laundering crime).

21. **In implementing supervision, domestic and international cooperation is essential to cover all material risk areas of a regulated financial institution.** The cooperation is particularly important to provide effective supervision and oversight of (i) a financial conglomerate engaged in banking, insurance, securities, and/or other financial activities; (ii) a financial institution that operates in more than one jurisdiction; or (iii) a financial institution whose size or activities are systemically relevant in relation to the financial system.

22. **The necessity of cooperation for prudential purposes is highlighted by each of the three financial sector supervision standard-setters, who have issued guidance for the exchange of supervisory information.** The Basel Committee has issued two papers, “Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments” (July 1992), and “Report on the Supervision of Cross-border Banking” (October 1996). IOSCO issued guidance in “Principles for Memoranda of Understanding” (1991). Finally, the IAIS issued its standard in a section of the Insurance Concordat titled “Principles applicable to the Supervision of International Insurers and Insurance Groups and their Cross-border Establishments.” Supervisory cooperation is also fostered through various regional supervisory groupings.¹²

23. **Information exchange related to criminal or civil law enforcement purposes, particularly money laundering crime and terrorist finance, varies from that for supervisory purposes as the objective behind the exchange is to prevent or solve individual crimes.** It is essential for national authorities to create mechanisms whereby financial information relevant to the prevention of money laundering and terrorism finance is collected, analyzed, and disseminated to appropriate supervisory and law enforcement authorities. Integral to the information exchange mechanism is that financial institutions must

¹¹ The Fund’s assessments of OFCs typically include, in addition to a review of the licensing and regulation of a variety of financial sector services, the regulation and supervision of company and trust service providers, and the licensing of companies.

¹² Regional supervisory groupings include for example the Association of Supervisors of Banks of the Americas; the Arab Committee on Banking Supervision; the Eastern and Southern Africa Banking Supervisors Group; and the Offshore Group of Banking Supervisors.

report instances when there is reasonable basis for suspicion of criminal activity. The typical process is one where the financial institutions are required to make suspicious activity reports, often through their national supervisors, to a financial intelligence unit (FIU; see Annex V). The FIU is frequently operated from within a finance or justice ministry. The FIU acts as the central repository to gather information, primarily in the form of suspicious activity reports, from financial institutions or other sources and turns this raw reporting into intelligence that is provided to the appropriate government authority to support a national anti-money laundering effort.

24. **The overall effectiveness of fighting money laundering crime (and now terrorism finance), which often involves financial transactions in more than one country, depends on the sharing of information and intelligence among several jurisdictions.** This sharing of information, frequently involves interaction between FIUs, law enforcement agencies and supervisory agencies. Through the sharing of information, money-laundering crime, and now the financing of terrorists, can be discovered and appropriate law enforcement be brought to bear. While there have been some advances in cooperation among FIUs (in particular there is a trend towards greater regional cooperation in the European Union, the Caribbean, and the Pacific Islands region), there is currently no formal global multilateral framework in place. However, international cooperation is encouraged through the informal association within the Egmont Group.¹³

25. **While the primary responsibility for strengthening information sharing and avoiding critical information gaps lies with supervisors and other national authorities, the Fund can play a facilitating role in its assessments and technical assistance.** For example, compliance with supervisory standards in information exchange is assessed in FSAP and OFC work. Also, the Fund-Bank Methodology Document expressly considers the legal and regulatory requirements whereby financial institutions must report suspicious activity to the FIU or other proper authority. Also, the methodology document inquires about the mechanism in place for sharing suspicious activity reporting information with foreign authorities.

IV. THE FUND'S COMPARATIVE ADVANTAGES AND COORDINATION WITH OTHER GROUPS

A. The Fund's Mandate and Expertise

26. **A range of activities is available to allow the Fund to intensify its involvement in anti-money laundering policies and extend its activities to support systems to combat the financing of terrorism. The Fund should pursue those activities that exploit the Fund's core competencies and capacities, recognizing its unique global coverage and its expertise in certain financial sector issues.** The Fund is a collaborative institution with near universal membership, which lends the Fund legitimacy and acceptance, and makes it a

¹³ The Egmont Group, established in 1995, serves as an informal association of FIUs, promoting best practice among FIUs and international cooperation in the fight against money laundering.

natural forum for sharing information and developing common approaches to issues. These strengths also make the Fund a vehicle for actively promoting desirable policies and standards in member countries.

27. **The Fund has broad experience in conducting assessments and providing technical assistance in the financial sector.** FSAPs, conducted jointly by the Bank and Fund, are the preferred vehicles to identify gaps and vulnerabilities in financial sectors, and ROSCs and FSAPs allow compliance with agreed international standards to be assessed. The FSSAs derived from FSAPs and Article IV consultation discussions, and the financial sector ROSC modules contained in the FSSAs are explicitly integrated in the Article IV consultation discussions and reports to the Board. They thus inform the Fund's surveillance activities.¹⁴ At the same time, technical assistance in strengthening financial systems is increasingly being targeted to support follow-up on FSAP and ROSC assessments.

28. **In addition, the Fund has long experience in exercising surveillance over members' exchange systems** in the context of Article IV missions, and providing technical assistance to reform such systems as part of its core mandate to assist in the development of a multilateral system of payments for current international transactions. In this context the Fund has often had to address issues relating to exchange and currency transactions in parallel exchange markets outside of official supervision, which can provide channels for money laundering and the financing of terrorism. Fund surveillance, advice, and technical assistance in this area has sought, inter alia, to eliminate distortions and restrictions in the exchange system, and to rectify deficiencies in the foreign exchange market organization and infrastructure, and thus to reduce the importance of the parallel exchange markets.

29. **Yet, the Fund has a limited mandate and must respect the sovereignty of its members and the division of labor and responsibilities with other international organizations.** In April 2001, the Board stressed that money laundering issues should continue to be addressed in Fund surveillance when they have macroeconomic effects, including effects arising from financial instability and reputational damage.¹⁵ A number of Directors considered that the cross-border implications of money laundering should be raised during Article IV consultations, even if it is not macroeconomic relevant for that member but when it had significant externalities for other countries. With regard to conditionality, many Directors were of the view that the "macro-relevance" test should continue to be applied, but a few Directors were opposed to applying conditionality to anti-money laundering measures. In July 2001, Directors agreed that those measures that are critical to achieving a program's macroeconomic objectives should continue to be included in Fund conditionality, with a number of Directors stressing the need for strong justification when including measures outside the Fund's core areas of responsibility and expertise. Some Directors cautioned against applying this criterion too narrowly, noting that in some cases criticality might be

¹⁴ See SM/00/263 and BUFF/00/190 for a review of FSAP/FSSA process.

¹⁵ See BUFF/01/54.

difficult to define ex ante, and that there is a risk that important areas of reform would not be properly covered.¹⁶

30. **Under the Board's existing policies and guidance in the area of anti-money laundering policies, attention has focused on the Fund's capacities in the areas of technical assistance and the assessment of financial systems.** The April Board decision emphasized the Fund's efforts in assessing compliance with financial supervisory principles and providing corresponding technical assistance. However, implementation of financial supervisory principles is not readily separable from the legal framework in which they are applied, and depends on other institutional structures.¹⁷ This distinction is made more complicated as the objective is extended to encompass the combating of terrorist financing. The staff has already been involved in advising countries on AML legislation, and, in a limited number of cases, the registration of nonfinancial intermediaries and the creation of FIUs. The August report containing the draft AML Methodology Document makes reference to communication and cooperation between supervisors and relevant enforcement bodies. The Fund is not able or mandated to become involved in law enforcement, but greater attention to issues of immediate relevance to the effectiveness of financial sector policies, and especially financial supervisory principles is feasible and worthwhile.

B. Coordination with FATF

31. **There was broad agreement at the Fund Board in April that the FATF, as the standard-setter in the field, should be strengthened in order to carry out its (expanding) functions effectively.** While FATF (like a number of other standard-setters) has a limited membership, the worldwide acceptability of its AML standards, the processes by which they are assessed, and how the results used are crucial to an invitation to participate in the ROSC process.

32. **The FATF convened the working group charged with the development of the assessment methodology for the FATF 40 Recommendations (FATF 40 ROSC working group).** The working group, chaired by the United States, includes Fund and Bank participants. In conjunction with the recent extraordinary plenary meeting in Washington, the working group discussed an initial draft assessment methodology and agreed to a preliminary timetable for completing a final version by the next plenary meeting in February 2002. At this juncture, the working group has elected to confine the assessment methodology to the current version of the FATF 40 Recommendations (i.e., the 1996 version) and not take up the special recommendations for countering terrorist financing. There was agreement within the

¹⁶ See BUFF/01/122, *Summing Up by the Chairman Streamlining Structural Conditionality—Review of Initial Experience; IMF-World Bank Collaboration on Program Conditionality; and Conditionality in Fund-Supported Programs—External Consultations Executive Board Meeting 01/79 July 27, 2001.*

¹⁷ Annex II contains a further discussion of the relationship between financial supervisory principles, the legal and institutional framework, and law enforcement matters.

working group that (i) the assessment criteria needed more precision to ensure consistency of application by assessors and (ii) that the detailed criteria from the Fund and Bank's AML methodology document should be incorporated into the FATF assessment methodology. Thus, progress in this work has been made, but some major issues still need to be resolved.

33. At the meeting, staff noted that, **while the IMF and Bank will help to draft the assessment criteria for the supervisory and regulatory elements for the banking, insurance and securities sectors, the FATF was to develop the objective and specific guidance in the criminal and civil law enforcement areas.** In particular, the FATF was to develop criteria for assessing cooperation and information sharing in criminal investigation and prosecution; guidance on elements that should be present in mutual legal assistance treaties; and the minimum requirements for what constitutes a predicate offense, that is, a crime that gives rise to the funds that are laundered.

C. Coordination with the World Bank and Other Organizations

34. **The World Bank Executive Board agreed in April 2001 that the Bank can play a supportive role, in partnership with the IMF and others, to help countries strengthen their defenses against money laundering and other financial abuse.** In particular, it was mandated that the Bank in collaboration with the Fund should address these issues in FSAPs, and provide related technical assistance.^{18 19} The Bank has recently established an AML Coordinating Committee, and is expected to embark on an extensive training program for both Bank staff and officials from member countries on the global standards of AML policies, procedures, and implementation. In addition, the Bank has begun exploring with the Fund mechanisms to expedite and coordinate the delivery of technical assistance in response to country requests following FSAPs.

35. **In addition to FATF and the World Bank, there are a number of organizations and bodies involved directly or indirectly in countering money laundering and the financing of terrorism.**²⁰ These include the regional anti-money laundering organizations (whose mandate is being expanded to include terrorism finance); the UN, including the Security Council (and the Committee charged with overseeing Resolution 1373) and the UN agencies whose mandate extends to transnational crime (the UNDCCP and UNDCP); the international standard-setting bodies in the area of financial sector regulation/supervision such as the Basel Committee, IOSCO, IAIS, and the International Federation of Accountants; and other financial supervisory bodies such as the Offshore Group of Banking Supervisors (OGBS), and the Offshore Group of Insurance Supervisors (OGIS).

¹⁸ The Bank has only limited involvement in Module 2 of the Off-shore Financial Center (OFC) assessments.

¹⁹ The Bank has recently provided technical assistance in Albania, Colombia, Mauritius, Turkey, and Ukraine covering such topics as AML legislation and the establishment of an FIU.

²⁰ See also SM/01/103, Annex I and SM/01/46, Annex VI.

D. Coordination of Technical Assistance

36. **The provision of Fund technical assistance on financial sector issues already involves coordination with supervisory and regulatory authorities and standard-setting bodies.** This has included assistance in creating and enhancing the legal and institutional framework for supervision, for example by drafting and reviewing laws and capacity and institutional building. With respect to assistance on countering money laundering, the Fund has coordinated with regional anti-money laundering organizations and with the UNDCCP and UNDCP. For example, a comprehensive technical assistance project on AML and financial fraud in the Pacific Islands, which involves setting up a regional FIU, has included the creation of a coordinating unit comprised of the participating countries, the UN UNDCP, the Asia Pacific Group on Money Laundering, and the Pacific Islands Forum.²¹ This Coordinating Office for the Participating Countries Anti-Money Laundering Initiative (COAMLI) operates as a consultative group, and is supported by an expert in anti-money laundering operations in the Asia Pacific region. COAMLI ensures that each participating organization provides technical assistance in the appropriate area.

V. MEASURES FOR INTENSIFYING THE FUND'S INVOLVEMENT

37. The considerations presented above suggest the direction in which the Fund's involvement in AML might be intensified and extended to combating the finance of terrorism. **The specific elements have been selected on the basis of their expected contribution to (i) achieving results, including the strengthening of the international financial system; (ii) maintaining consistency with the policies in place; (iii) exploiting Fund expertise and limiting the resource demands; and (iv) achieving "ownership" by member countries.**

38. **The approach goes substantially and visibly beyond that envisaged in the April Board decision, yet does not go outside the Fund's mandate or area of expertise.** The elements presented are those that seem essential to achieve a qualitative and quantitative intensification of the Fund's involvement in AML and combating the financing of terrorism. Furthermore, the suggested measures seem appropriate and feasible at this time; the Board could revisit the issue and consider additional measures after the effectiveness of this approach has been assessed, taking account also of the need for flexibility in the light of rapidly changing events and initiatives. The measures proposed below indicate the direction for future work, and additional technical refinement of the proposals is needed before implementation can be initiated. The approach would not create the need for any special procedure not used elsewhere in the Fund's work.

- **The Fund-Bank AML Methodology Document would be amplified and expanded by including:**

²¹ A regional FIU not only allows the participating countries to share the fixed costs of establishing the institution, but may also be more effective in collecting and analyzing information on related transactions in different jurisdictions.

- (i) **relevant parts of the anti-terrorism financing recommendations of the FATF** (see Annex I and Annex II). The recommendations relating to the reporting of suspicious transactions and remittance and wire-transfer systems have implications for a range of financial sector standards, including standards on payments system design and oversight.
- (ii) **legal and institutional issues related to the effectiveness of financial sector policies in this area** (see Annex II). Added to the prudential supervisory aspects of AML would be relevant legal and institutional issues such as the extension of KYC and other anti-terrorism finance AML/principles to the unsupervised sector, the existence of a suitable legal framework including criminal and civil statutes, institutions for effective implementation (including FIUs), resources and training needs of supervisors, and bilateral or multilateral arrangements for the exchange of information. Many of these topics can be addressed only by considering the relationship between the financial supervisor, financial institutions, and such organizations as the national and foreign FIUs.

Once drafted, the expanded Methodology Document would be circulated to the Board to update the earlier document circulated in August 2001.

- **The expanded AML Methodology Document would be applied in all FSAP and OFC assessments.**²² The AML assessment would be presented in detail as part of FSAP reports to the authorities, and would be included as a substantive chapter in the related FSSA reports, which, as now, would be made available to the Board. In addition, countries would be encouraged to approve the distribution of the detailed assessments in this area (either as separate documents or as part of larger technical assistance reports) to the Board and relevant bodies, such as the FATF. Thus, the range of countries to which the AML Methodology Document would apply would be expanded, and the results could be made more widely available.
- **The number of OFC assessments to be concluded would increase from a target of 10 to a target of 20 per year;** at the accelerated pace, the Fund OFC program would have conducted assessments of some two-thirds of all the 42 OFCs in the Financial Stability Forum list by the end of 2002; OFC assessments would be completed in about two years rather than four, as currently envisaged. Most of the OFC assessments would be of supervisory standards (Module 2), and would include in 2002 many of the larger, systemically more important OFCs.
- **Where an FSAP or OFC assessment had been undertaken, the Article IV consultation mission would be expected to follow up** on the authorities' reaction to the relevant AML report, and on the implementation of recommendations in the area

²² There could be technical assistance requests for stand alone assessments of supervision of the banking, insurance, and capital markets sectors. Assessments would be based on the amplified AML Methodology Document.

of AML and combating the financing of terrorism. The results of the discussions would be mentioned in the staff report.

- **When a recent assessment of a country's AML and anti-terrorism financing regimes is not available, the related issues would be addressed in the staff report on the Article IV consultation discussions on a case-by-case basis, based on potential macroeconomic relevance. To this end, a limited questionnaire (based on the expanded staff AML methodology) could be distributed to members.** The questionnaire would be designed to provide a broad overview of the current status of efforts to improve the application of financial regulatory principles in the areas of AML and anti-money laundering and related legal and institutional issues. A preliminary draft of some elements that might be included in the questionnaire—**completion of which would be voluntary**—is included in Annex VI. The results could inform Article IV consultation discussions, be used in determining topics for further discussion or determining cases where technical assistance or FSAPs may be warranted, and could facilitate “the preparation of studies designed to assist members in developing policies, which further the purposes of the Fund.”²³ If a member chose not to complete the questionnaire, the Board would be notified, including the reasons given by the authorities.
- It is suggested to start the process by piloting the questionnaire in the countries in which the AML Methodology is currently being applied, on the basis of which experience the questionnaire could be refined. **The questionnaire could then be phased in, probably starting in spring 2002, with the aim of eventually covering the whole membership.** Countries would be selected for early receipt of the questionnaire based on a judgment on macroeconomic relevance—based on the undertaking of reforms and legislative changes that might affect the integrity and stability of the domestic and international financial systems, and systemic importance, including possible cross-border effects—and considerations of balanced geographic coverage.
- **The Fund is contributing to revisions to the FATF 40 and the associated FATF 40 Methodology Document; and will work closely with FATF in finalizing an AML ROSC procedure as soon as possible.** Fund staff would work with FATF on how best to conduct assessments, and how the FATF assessments could benefit from Fund and Bank work in the context of FSAPs (for instance, by AML reports being made available, if the member agreed, to FATF). Fund and Bank staff could also work closely with FATF on that part of the FATF 40 which will be covered by the expanded AML Methodology Document.
- **The amount of technical assistance in this area would be increased.** This technical assistance work would aim to help national authorities better understand and supervise the management by financial institutions of relevant AML and anti-terrorist finance issues. The assistance could include helping countries address deficiencies in

²³ See Article VIII, section 5(c) of the Articles of Agreement.

financial supervisory arrangements, either onshore or offshore—deficiencies which could relate also to the legal and institutional framework and to their practical implementation. In the area of the legal and institutional framework, assistance might be provided, for example, in the drafting of laws, regulations, and supervisory guidance that conforms to accepted standards; in the establishment and development of FIUs, possibly on a regional basis; and in the drafting of bilateral or multilateral arrangements on cooperation in this area. The technical assistance would be provided primarily in response to deficiencies identified in the course of FSAPs and OFC assessments. Circulation to the Board could be encouraged for countries that receive this increased technical assistance, in order to help keep the Board informed in an area where cross-border effects can be extremely important.²⁴ In addition, the proportion of technical assistance currently aimed at improving formal payment and remittance systems could be increased, in order to direct more of this work at countries where (often because formal systems are inadequate) extensive use is made of informal systems, which can be used for the purposes of money laundering or terrorist finance.

- **The Fund and the Bank could take a more active role in coordinating technical assistance in AML and countering the financing of terrorism.** The coordination role should cover technical assistance in the supervisory and legal and institutional areas, in which the Fund's role in FSAPs and OFC assessments would be directly relevant. It would then be easier to monitor the distribution and effectiveness of assistance. This coordination function would have to be integrated with on-going Fund-Bank efforts to strengthen the design, delivery, and coordination of financial sector technical assistance, including through following up on FSAP and ROSC assessments.
- **Further research and analysis would be undertaken on relevant issues, including alternative remittance and payments systems, and corporate and nonprofit vehicles.** This analysis could address such issues as the possible incidence of money laundering and the operations of alternative remittance and payment systems.

VI. RESOURCE DEMANDS

39. **The more the Fund broadens the scope of its work** to include AML and anti-terrorism activities, extends its work throughout the entire financial sector and even beyond, and accelerates its work by doing more OFC assessments and other technical assistance in a shorter time frame, **the larger the resource implications.** The Board has requested that there

²⁴ Under the current policy, the distribution and publication of technical assistance documents require the consent of the authorities and approval by management. Changing this policy, and especially weakening the requirement for the authorities' consent before distributing a technical document to the Board, raises broader policy issues. The conditions under which specific categories of technical assistance reports could be circulated to the Board or be made public will be considered by the Board as part of the review of technical assistance policy scheduled for March 2002.

should be no unfunded mandates, and this section presents a preliminary assessment of resource implications.

40. **The total full year dollar cost of the proposed approach is provisionally estimated at some US\$8 million** (pending more complete information on the actual work program, which can be developed following the discussion by the Executive Board). **This estimate provides for 14 extra regular staff years in MAE and LEG alone**, most of whom would need to have specialized supervisory skills, along the lines of the table below. Any additional staff resource costs for PDR, area and other departments have yet to be fully projected.²⁵ The dollar estimate also includes a projected 10 person years for short-term and long-term experts (6 for LEG and 4 for MAE, which are not included in the table below), and the necessary support (infrastructure costs such as office space, travel, and support department costs).²⁶

Distribution of Additional Regular Staff

(In staff years)

	MAE	LEG	Total
AML Methodology Assessment in all 24 planned FSAPs 1/	1	0.5	1.5
Ten additional OFC assessments, including AML Methodology Assessment	3	0.5	3.5
Increased planned technical assistance	1	0.5	1.5
Limited questionnaire on AML and combating terrorism financing 2/	1	0.5	1.5
Coordination of technical assistance	1		1
Supervisory and support staff	2	2	4
Further research and analysis	1		1
Total	10	4	14

1/ Assessment of compliance with AML Methodology Document.

2/ It is envisaged that not all members would be covered immediately. For purposes of calculating resource costs, it is envisaged that 50 questionnaires would be sent out and analyzed each year.

41. **These estimates are on a full year basis for FY2003; costs in the current fiscal year are likely to be small**, but will need to be examined further. The costs for FY2004 would be a little higher (two additional regular staff years are envisaged costing some

²⁵ Preliminary projections suggest that PDR may need one or two additional regular staff, and area departments may need one or two additional regular staff spread over different departments. In addition, depending upon the Board guidance, the resource estimates for LEG and MAE would need to be revisited.

²⁶ Support activities also include recruitment, computer purchases, software licensing, etc.

\$410,000); and the composition would change after all OFCs had been assessed at least once, while technical assistance and policy development demands could increase.

42. These tentative estimates have been discussed with the Office of Technical Assistance Management and the Office of Budget and Planning. They will be refined in consultation with concerned departments.

VII. SUMMARY

43. **Money laundering and the financing of terrorism are global problems that affect not only security, but also potentially harm economic prosperity and the state of the international financial system.** The Fund's mandate and core areas of expertise entail that it can and should help its member countries strengthen their defenses against these pernicious activities. The Board decided in April 2001 to enhance the Fund's activities in AML, notably through the development and application of a detailed methodology to assess compliance with relevant financial supervisory principles, and closer cooperation with FATF, which is the recognized standard-setter in this area. Work has already begun in implementing this Board decision. For example, the current AML methodology is being applied in pilot cases, and Fund staff have contributed to the recent actions by FATF to prepare an AML ROSC module.

44. **Recent events make the Fund's contribution more urgent, and prompt a reexamination of what additional areas should be addressed in the Fund's work.** It has become clearer that protecting against abuses such as money laundering and the financing of terrorism requires effective supervision, national coordination and cooperation into the collection and processing of relevant information, and fluid cross-border exchange of information in both offshore and onshore financial centers. Combating the financing of terrorism is distinct from AML efforts, but they share some common elements, and international standards addressed directly at the former are now being developed. Relevant components of these standards can be added to the Fund's assessment of supervisory principles, and promoted through associated technical assistance. At the same time, the Fund must recognize in its assessments and technical assistance that effective preventative measures depend not only on adherence to financial supervisory principles, but also upon the legal and institutional framework in which those principles can be applied, and coordination with measures covering the unsupervised financial sector.

45. **On this basis the Fund could adopt a number of measures to intensify its involvement in AML and combating the financing of terrorism.** First, the scope of FSAPs and OFC assessments could be expanded to include a more detailed evaluation of financial policies and in particular supervisory principles and the legal and institutional framework related to both AML and combating the financing of terrorism. Second, the provision of related technical assistance and OFC assessments could be accelerated. Third, these issues could receive more attention in Article IV consultation discussions, for example, in following up recommendations contained in FSAPs. Finally, the Fund would cooperate closely with the FATF so that the FATF can move ahead rapidly with an appropriate AML ROSC procedure. **These measures would go beyond the April 2001 Board decision by addressing anti-terrorism financing, and broadening the scope of the staff's work to cover the legal and**

institutional framework in which financial sector policies and financial supervisory principles are applied to prevent money laundering and the financing of terrorism.

46. These additional measures, taken together, would add substantively to the Fund's output in this area, and to the international effort to counter money laundering and terrorist finance. **The Fund would provide significant reinforcement to national authorities, and especially supervisors, in developing the architecture of preventative systems in the financial sector, which form one essential component of this effort. Yet, the Fund's contribution will be limited.** The Fund is not and will not be in a position to identify or help others identify individual instances of money laundering or terrorist financing. Nor will it normally be possible for regulated institutions to identify small amounts of money from legitimate sources—which may often be the way in which terrorism is financed.

VIII. ISSUES FOR DISCUSSION

47. **The summing up of the Board's discussion of this paper provides an opportunity for Executive Directors to decide how the Fund's efforts in AML should be further intensified and how to extend them to cover the combating of terrorism financing.** The Board may wish to consider the following issues for discussion:

- Do Directors agree that the Fund should intensify its contribution in its core areas of expertise to global efforts to combat money laundering and the financing of terrorism? Do they agree that the set of measures presented in this paper represents a broadly appropriate immediate response to current circumstances, consistent with the Fund's mandate? Do they agree that the work needs to be carefully monitored in the light of experience, and should be revisited in one year's time?
- Do Directors agree to expand the issues covered in the joint Fund-Bank AML Methodology Document and technical assistance to include aspects relating to combating terrorism financing? Is it appropriate that the AML methodology and technical assistance be expanded to cover not only financial supervisory aspects, but also the relevant legal and institutional framework? Should the expanded AML methodology be applied in all FSAPs and all OFC assessments? Do Directors agree to an acceleration in the pace of OFC assessments?
- Do Directors favor an increase in technical assistance to correct deficiencies in AML and combating the financing of terrorism identified in the course of FSAPs and OFC assessments, and include additional work on helping prepare AML legislation and develop FIUs at the national level? Do they support a greater role for the Fund in the coordination of technical assistance in these areas?
- Do Directors agree that information sharing and cooperation among national authorities and international constitute a key element in combating money laundering and terrorism financing effectively? Do Directors agree that these activities are primarily the responsibility of member governments?
- Would a questionnaire based on the expanded AML methodology be useful in monitoring these issues?

- Do Directors support enhanced collaboration with FATF, and do they confirm that the Fund should contribute to revisions to FATF 40 and the associated FATF 40 Methodology Document, and continue to work towards the timely finalization of an assessment process by FATF that is uniform, cooperative, and voluntary?
- Do Directors agree that more resources are needed to fulfill the suggested task? Do they agree with the preliminary resource estimates contained in Section VI?

FINANCING OF TERRORISM

Conceptual and Legal Issues

1. In general, money laundering involves the processing of the proceeds of crimes already committed so as to disguise their illegal origin, while the financing of terrorism involves the processing of funds (often legitimately acquired) to be used in future crimes. As a result, many of the measures to deter money laundering, especially those that involve identifying criminal proceeds, are not effective in deterring terrorism. However, while what constitutes “laundering” and “financing” are understood and broadly accepted, what constitutes a predicate crime to money laundering and what constitutes the crime of terrorism are not. Terrorism involves certain actions, such as kidnapping, extortion, assault, murder, or the destruction of property, that are themselves already serious crimes. The concept of terrorism as a separate crime relates to the reason or purpose for which these already serious crimes are carried out.
2. The 1999 International Convention for the Suppression of the Financing of Terrorism, which was adopted by the UN General Assembly but is not yet in force (ratified by only four countries), contains extensive provisions on international cooperation against financing for terrorism. The Convention’s definition of terrorism is based on two alternative criteria: terrorism is either an offense within the scope of one of the treaties listed in the annex to the Convention (e.g., hijacking of aircraft, bombings, taking of hostages) or “any other act intended to cause death or serious bodily injury to a civilian, or to any other person not taking an active part in the hostilities in a situation of armed conflict, when the purpose of such act, by its nature or context, is to intimidate a population, or to compel a government or an international organization to do or to abstain from doing any act.”
3. International law has generally recognized that governments need not cooperate in criminal matters when the act was also political in nature; this is because governments may differ as to whether a violent act might be acceptable due to a compelling political justification. The Convention would exclude this political exception.
4. The Convention also establishes a duty to investigate persons suspected of financing terrorism, to avoid the risk of flight by an offender (or alleged offender), to make terrorism an extraditable offense, and to refer for domestic prosecution those offenders who are not extradited. Prosecutorial discretion is maintained. The Convention provides no sanctions for countries if they fail to cooperate.
5. The Security Council’s Resolution No. 1373 (2001) of September 28, 2001 requires the adoption by all States of certain measures against terrorism, and creates a Committee, chaired by the United Kingdom, to report within 90 days on compliance with the Resolution. The Resolution includes no definition of terrorism. Presumably, however, the Council will define, on a case-by-case basis, the acts of specified persons as terrorism. In fact, a list of persons or entities regarded as terrorists had already been adopted by the Security Council Committee concerning Afghanistan Issues (established by Resolution No. 1333 (2000), paragraph 8(c)); this list has been amended after September 11, 2001, and includes, for instance, a number of

fundamentalist Islamic groups such as Al Qaeda or persons such as Usama Bin Laden (AFG/150, Security Council/7166, October 8, 2001).

6. With respect to the financing of terrorism, paragraph 1 of the resolution requires each state to prevent and suppress the financing of terrorist acts, criminalize the willful financing of terrorism, freeze the assets of terrorists and related entities, and prohibit payments to terrorists and related entities. Moreover, the resolution imposes an obligation on all States to “bring to justice” terrorists or persons assisting or funding terrorist activities; although the concept of “bringing to justice” is not defined by the resolution, it would seem that this obligation may be performed either by extraditing the offender or prosecuting the offender in local courts. The same resolution calls upon—but does not require—all states to become parties to the UN Convention for the Suppression of the Financing of Terrorism of December 9, 1999.

FATF Special Recommendations on Terrorist Financing

The following statement was issued following the FATF extraordinary plenary meeting:

7. Recognizing the vital importance of taking action to combat the financing of terrorism, the FATF has agreed these Recommendations, which, when combined with the FATF 40 Recommendations on money laundering, set out the basic framework to detect, prevent, and suppress the financing of terrorism and terrorist acts.

Ratification and implementation of UN instruments

8. Each country should take immediate steps to ratify and to implement fully the 1999 United Nations International Convention for the Suppression of the Financing of Terrorism. Countries should also immediately implement the United Nations resolutions relating to the prevention and suppression of the financing of terrorist acts, particularly United Nations Security Council Resolution 1373.

Criminalizing the financing of terrorism and associated money laundering

9. Each country should criminalize the financing of terrorism, terrorist acts and terrorist organizations. Countries should ensure that such offenses are designated as money laundering predicate offences.

Freezing and confiscating terrorist assets

10. Each country should implement measures to freeze without delay funds or other assets of terrorists, those who finance terrorism, and terrorist organizations in accordance with the United Nations resolutions relating to the prevention and suppression of the financing of terrorist acts.

11. Each country should also adopt and implement measures, including legislative ones, which would enable the competent authorities to seize and confiscate property that is the proceeds of, or used in, or intended or allocated for use in, the financing of terrorism, terrorist acts or terrorist organizations.

Reporting suspicious transactions related to terrorism

12. If financial institutions, or other businesses or entities subject to anti-money laundering obligations, suspect or have reasonable grounds to suspect that funds are linked or related to, or are to be used for terrorism, terrorist acts or by terrorist organizations, they should be required to report promptly their suspicions to the competent authorities.

International cooperation

13. Each country should afford another country, on the basis of a treaty, arrangement or other mechanism for mutual legal assistance or information exchange, the greatest possible measure of assistance in connection with criminal, civil enforcement, and administrative investigations, inquiries and proceedings relating to the financing of terrorism, terrorist acts and terrorist organizations.

14. Countries should also take all possible measures to ensure that they do not provide safe havens for individuals charged with the financing of terrorism, terrorist acts or terrorist organizations, and should have procedures in place to extradite, where possible, such individuals.

Alternative remittance

15. Each country should take measures to ensure that persons or legal entities, including agents, that provide a service for the transmission of money or value, including transmission through an informal money or value transfer system or network, should be licensed or registered and subject to all the FATF Recommendations that apply to banks and nonbank financial institutions. Each country should ensure that persons or legal entities that carry out this service illegally are subject to administrative, civil, or criminal sanctions.

Wire transfers

16. Countries should take measures to require financial institutions, including money remitters, to include accurate and meaningful originator information (name, address, and account number) on funds transfers and related messages that are sent, and the information should remain with the transfer or related message through the payment chain. Countries should take measures to ensure that financial institutions, including money remitters, conduct enhanced scrutiny of and monitor for suspicious activity funds transfers, which do not contain complete originator information (name, address, and account number).

Nonprofit organizations

17. Countries should review the adequacy of laws and regulations that relate to entities that can be abused for the financing of terrorism. Nonprofit organizations are particularly vulnerable, and countries should ensure that they cannot be misused:

- (i) by terrorist organizations posing as legitimate entities;

- (ii) to exploit legitimate entities as conduits for terrorist financing, including for the purpose of escaping asset freezing measures; and
- (iii) to conceal or obscure the clandestine diversion of funds intended for legitimate purposes to terrorist organizations.

AML ELEMENTS IN SUPERVISORY PRINCIPLES, AND POSSIBLE SCOPE FOR AN EXPANDED METHODOLOGY

Supervisory Principles Related to AML, and the Supporting Legal and Institutional Framework

1. The Basle Committee, IOSCO, and IAIS each have included due diligence reviews on those who control or use regulated financial intermediaries, which includes both fitness tests for owners/managers and know-your-customer rules (KYC). KYC procedures with respect to customers (as amended to include the prevention of terrorism finance) involve (i) identifying if the potential or actual customer (or beneficiary), or the maker or recipient of assets transfers, is a criminal or terrorist; (ii) reporting transactions that suggest criminal activity to the appropriate authorities; and (iii) cooperating with supervisors and law enforcement agencies and (iv) putting in place anti-money laundering policies, procedures and training.
2. These procedures are designed primarily to control three types of risk, the first two of which relate to the use of institutions for laundering money or financing crime. These are reputational risk (the public's confidence in the integrity of the institution can be damaged if it is used as a vehicle for advancing serious crime) and operational and legal risk (failure to control money laundering or the financing of terrorism can result in the seizing of tainted assets held by the institution, as well as the imposition of fines or penalties on the institution itself).¹ If risk is controlled for individual institutions, risk to the financial system is also controlled.
3. To be effective, principles of financial supervision must be implemented, which requires that supervisors have (i) the authority to require adherence to the supervisory principles and (ii) the means to administer them. Both require that there be adequate sanctions (which can involve regulatory, civil, and even criminal sanctions) to deter non-compliance. This includes having in place both the appropriate statutory authority and effective administrative and adjudicatory institutions (including for civil and criminal prosecution), including procedures for sharing of information relevant to supervision with other domestic and foreign supervisory agencies.

The Current Methodology Document

4. The Fund-Bank AML Methodology Document, which is still in draft form, guides assessment teams in the review of AML elements in Fund and Bank financial sector assessment activities related to the financial sector assessment program (FSAP) and the offshore financial center (OFC) initiative. The methodology document is intended to ensure both comprehensiveness and uniformity in the assessments of the AML elements in financial sector supervisory standards. It is now being used, with agreement of the authorities, in FSAPs in Luxembourg, Switzerland, Sweden, and the Philippines.

¹ The third, concentration risk, relates to identifying customers so as to be able to aggregate beneficial ownership of assets and liabilities for purposes of limiting exposure to any one client.

5. The starting point for the Fund-Bank Methodology Document was the existing principles of prudential supervision, in the areas of banking, securities, and insurance, determined by the standard-setting bodies. Of particular importance is Basel Core Principle 15 on preventing banks being used by criminal elements; IAIS Core Principles 1–5, 10 and 16; and IOSCPO principles 5, 10–13, 17, 21 and 23. These basic principles are augmented by the criteria developed in the standard-setters' own methodology papers, additional and later papers by the supervisory standard-setters relevant to AML work, and on the FATF 40 Recommendations.

6. The Fund-Bank Methodology Document assesses the AML elements present within the financial sector supervisory and regulatory framework to ensure that adequate controls and procedures are in place to prevent abuse of the financial system by criminals. Areas covered by the document include requirements for due diligence reviews on those who control or use regulated financial intermediaries (which includes both fitness tests for owners/managers and KYC rules) as a key part of these controls. Without this, financial institutions can become subject to reputational, operational, legal, and other risks. In all financial institutions, there are four basic anti-money laundering principles that should be adhered to:

- comply with anti-money laundering laws, including suspicious transaction reporting, to an administrative body or Financial Intelligence Unit (FIU);
- customer identification (KYC rules) and suspicious transaction monitoring;
- cooperation with supervisors and law enforcement agencies; and
- have in place anti-money laundering policies, procedures and training.

7. These principles are detailed and made concrete in the Methodology Document, which contains numerous specific criteria which should be met by an effective system to discourage and detect money laundering. These criteria include some related to such issues as the ability of the supervisor to share with domestic and foreign financial supervisory authorities information on suspected or actual criminal activities; the obligation of the supervisor to inform the relevant criminal and judicial authorities of suspected transactions; and the incorporation into laws and regulations international sound practices in this area. However, these legal and institutional issues are not covered in detail, and law enforcement issues are not emphasized as they are in the FATF 40 Recommendations. Issues relating to civil and criminal sanctions, including adjudicatory mechanisms, are not now included; nor are those matters that have only a secondary application to supervision, e.g. financial intelligence units (see Annex V). Nonetheless, 19 of the FATF 40 Recommendations have some counterpart in the supervisory principles elaborated in the current draft methodology document.

Possible Expanded Methodology

8. The purpose of the full 40 Recommendations (as amended to include the prevention of terrorism finance) is extensive: to prevent the financial system (as broadly defined) from being used to further crime. To be effective, this requires a host of additional measures that

extend beyond financial supervision, but each of which has an analogue in the legal and institutional framework for application of financial supervisory principles. These would include the extension of customer due diligence beyond the supervised sector, the criminalization of money laundering and the financing of terrorism, and the related administrative and adjudicatory institutions.

9. Expanding the Methodology Document to address the legal and institutional framework in which relevant financial policies and supervisory principles are applied would involve, first, elaborating further on some of the issues mentioned briefly in the current document, such as the criterion that the laws and/or regulations embody international sound practices, such as compliance with the relevant FATF 40 recommendations. Second, criteria would be added that correspond to several additional FATF 40 Recommendations, notably recommendations 1–3 on the general framework for the Recommendations (including ratification and implementation of the UN Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances); Recommendations 4–6 on criminalizing money laundering; Recommendation 7 on the legal authority to confiscate laundered property; Recommendation 30 on collecting information on international flows of cash and providing it to the Fund to facilitate international studies; and Recommendations 34 and 35 on establishing a network of bilateral and multilateral agreements, and ratification and implementation of relevant international conventions on money laundering. The expanded Methodology Document would thus cover to some degree 29 of the FATF 40 Recommendations.

10. The expanded Methodology Document would in addition include criteria related to the FATF Special Recommendations on Terrorism Financing (see Annex VI). The criteria in the Methodology Document would be based on the institutional aspects of those recommendations (such as the enactment of legislation to permit the seizure of property that is connected to terrorism financing), rather than those aspects that relate to enforcement (such as the actual freezing of assets).

11. Development of the Fund-Bank Methodology Document is running parallel to work by the FATF to develop an assessment methodology for the entire FATF 40 Recommendations. The substantive difference between these two efforts is that the FATF 40 assessment methodology will be used to assess all FATF 40 Recommendations, including criminal and civil law enforcement recommendations. Because of the overlaps between the two efforts, the Fund and Bank are participants in the FATF working group that is developing the FATF 40 assessment methodology. At the October 31, 2001 meeting the FATF working group agreed to incorporate into its assessment methodology the detailed criteria from the Fund-Bank AML Methodology Document dealing with supervisory and regulatory AML principles.

THE FATF, FATF 40, AND THE ROSC PROCESS

Organization of the FATF

1. The Financial Action Task Force on Money Laundering (FATF) was created by the G-7 in 1989 to develop and promote global anti-money laundering efforts. Today, the FATF has 29 members, whose delegations include representatives of finance and justice ministries, as well as law enforcement, legal, and financial sector regulatory experts.¹ The formal work of the FATF (policy development, planning, and assessments) is carried out largely through the plenary sessions, which meet normally three times a year. Topical policy development work is prepared by working groups formed from the FATF member delegations, meeting in the context of the plenary. Administrative and support functions are performed by a small secretariat based at the OECD. The FATF has two principal roles—that of a standard-setter and that of an assessor of compliance with the AML standard.

FATF's Role as a Standard-setter

2. In 1989, the FATF developed an international AML standard—The FATF 40 Recommendations (revised in 1996)—which cover the criminal justice system, law enforcement, international cooperation, and financial system regulation. In 2000, the FATF adopted the 25 criteria for assessing compliance of nonmembers with AML principles. These criteria have been used to identify the Noncooperative Countries and Territories (NCCT). Since September 2000, work is underway to revise and update the FATF 40 Recommendations and reconcile them with the NCCT assessment criteria (see below), with the objective of creating a uniform anti-money laundering standard. Following the September 11 events, the revisions also encompass the anti-terrorism financing measures.

FATF Role as Assessor of Compliance with AML Standard

3. The FATF carries out two types of assessments—the mutual evaluations, which are reserved for FATF members, and the NCCT assessments, which are nonvoluntary and applied only to non-FATF members. Though the two assessments have a similar AML objective, the NCCT process is based partly on the criteria that have not been included in the FATF 40 Recommendations. Furthermore, under the mutual evaluations for FATF members, noncomplying countries face no sanctions for noncompliance. In contrast, the NCCT assessments carry the threat of immediate sanctions for countries judged by the FATF as noncooperating. Currently there are 19 jurisdictions listed as noncooperative.²

¹ The 29 members are Argentina, Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States.

² Dominica, Egypt, Grenada, Guatemala, Hungary, Indonesia, Israel, Lebanon, Marshall Islands, Myanmar, Nigeria, Philippines, Russia, St. Kitts and Nevis, St. Vincent and the Grenadines, Ukraine, Cook Islands, Nauru, and Niue.

4. The FATF assessments—both mutual evaluation and NCCT—are carried out by experts drawn from the FATF member countries and include lawyers, regulators and law enforcement personnel with experience in criminal justice systems, law enforcement and financial sector regulation. The conclusions of these assessments are discussed in the plenary sessions.

Development of a ROSC for the FATF 40 Recommendations

5. In April 2001, the Fund's (and Bank) Board agreed that the FATF 40 Recommendations be recognized as the appropriate standard for combating money laundering, and the work should go forward to determine how the Recommendations could be adapted and made operational in the Fund's work. However, at that point most Directors felt that the Fund should only cover those issues in the FATF 40 Recommendations that deal with financial regulation and supervision, and that the responsibility for law enforcement related activities should be left to others. The Fund Board stressed that the FATF could be invited to participate in the preparation of a ROSC module on money laundering provided that the FATF AML standard and the assessment process are consistent with the ROSC process—that is, the standard needs to be applied uniformly, cooperatively, and on a voluntary basis.

6. A FATF working group (with Fund and Bank participation) is working on the revisions of the FATF 40 Recommendations and their reconciliation with the 25 NCCT criteria and is preparing an assessment methodology for the FATF 40 Recommendations that could be used to prepare AML ROSC modules. A preliminary draft has been reviewed and discussed at the end-October 2001, FATF plenary meeting and in the working group meeting. The next draft will be presented for the next FATF plenary meeting scheduled. It is envisaged that the drafting of the AML standard and of the assessment methodology will be completed by the FATF by February 2002.

7. In order to take an active role in managing the preparation of the AML ROSC modules, the FATF would need to strengthen its operational and policy development capacities, largely by hiring full-time professional staff. This is needed for the FATF to effectively organize and oversee assessments of the FATF 40 Recommendations, participate in assessment missions and ensure consistency and quality of the assessment process.

STANDARDS ASSESSMENTS AND ROSCs

1. The Fund (and Bank) Executive Board endorsed 11 areas and associated standards as useful for their operational work and for which *Reports on the Observance of Standards and Codes* (ROSCs) could be produced.¹ The Executive Board also agreed on a formal procedure for adding new standards to the agreed list, whereby the list should only be reviewed and modified by the Fund Executive Board, in consultation with the Bank when appropriate. It also left open the possibility of inviting other institutions to undertake assessments in their areas of competency.

Key Attributes of ROSCs

- The adoption and assessment of internationally recognized standards should remain voluntary.
- Assessments need to be independently conducted and consistently applied across countries.
- ROSCs should allow for the different stages of country economic development, range of administrative capacities, and the different cultural and legal traditions across the membership.
- ROSCs should provide the context for the assessment, including the progress made by the country in implementing standards, and the authorities' plans for further implementation. In this regard, caution should be exercised to ensure that Fund assessments do not resemble ratings for countries, and are not presented as pass-fail judgments.
- Members are to be assessed only against those standards, and those parts of standards, that are relevant to their situation. Accordingly, standards increasingly set out benchmarks for countries at different stages of development.
- Financial system standards are assessed generally in the context of FSAPs, and the summary assessments are then presented as part of FSSAs to serve as inputs into overall stability assessments that feed into surveillance, and are also issued as financial sector modules of ROSCs. Other standards, such as fiscal transparency, SDDS, corporate governance, etc., are typically assessed on a stand-alone basis.

¹ These include standards and codes on data, fiscal transparency, monetary and financial policy transparency, banking supervision, securities regulation, insurance supervision, payments systems, corporate governance, accounting, auditing, and insolvency and creditor rights.

Operational Aspects of ROSCs

2. The assessment of a country's observance of a given standard is based on the work of a mission during which expert staff hold in-depth meetings with the relevant country officials. It may also draw on questionnaires, self-assessments, or other information supplied by the country. Preliminary assessments are discussed with relevant country officials. The ROSC is a short summary assessment, which often draws on a more detailed assessment.
3. ROSC missions have to date been led by staff either from the Fund or the Bank, and often include external experts.
4. The Fund's Executive Board has recognized the important role that representatives of standard-setters and other institutions have played in developing assessment methodologies and in undertaking assessments, including through participation in assessment missions.
5. The conclusions of ROSCs inform surveillance. ROSCs themselves are background documents to the Article IV consultation and the main conclusions are incorporated into Article IV staff reports.

THE ROLE OF FINANCIAL INTELLIGENCE UNITS IN FINANCIAL SUPERVISION AND IN PREVENTING USE OF THE FINANCIAL SYSTEM BY CRIMINALS

1. Financial Intelligence Units (FIUs) play a variety of essential roles in combating the use of the financial system by criminals. FIUs (most of which have only recently been made operational) are designed principally to collect, process, and evaluate financial data and other information relating to financial transactions in the financial system. In so doing, they turn raw data into financial intelligence that can be used by both domestic and foreign law enforcement agencies to uncover fraud against financial institutions themselves as well as crimes that use the financial system as an instrumentality, including money laundering and the financing of crime.¹ FIUs are also typically engaged in other key activities, including:

- providing supervisors of the regulated financial sector with information in the context of assessing soundness of financial institutions and in processing license applications;
- issuing guidance and monitoring compliance with transaction reporting rules;
- conducting research into financial sector crime and recommending policy measures to detect and prevent such crime; and
- cooperating with similar entities in foreign countries to address cross-border issues, especially by sharing financial information and intelligence.

2. Some FIUs report to law enforcement agencies evidence of any crimes, including those that are not predicate offenses to money laundering or to financing of terrorism (e.g., evidence of tax evasion or nonfinancial crimes). In addition, some FIUs are engaged directly in law enforcement by investigating evidence of crime through their own initiative or through requests made by law enforcement agencies.

3. FIUs obtain the necessary financial information from three major sources:

- mandatory reporting of suspicious financial transactions. There is no single accepted standard governing which institutions have to make mandatory reports. The coverage can include, in addition to regulated financial institutions, any institution or person who regularly engages in large cash transactions or who makes or facilitates financial transfers (e.g., bureau de change, wire transfer agents, casinos, precious metals or gem dealers) and to professional intermediaries of financial services (e.g., lawyers and accountants);
- publicly available databases; and
- information exchanges with other regulatory and law enforcement bodies, including FIUs, both domestic and foreign.

4. As noted above, in some cases FIUs are also given investigative powers.

¹ In some instances, they also provide evidence to be used in prosecutions.

5. Transactions covered by the reporting requirement can be divided into two types: (1) all transactions of a particular type on a systematic basis, and (2) selective transactions that appear to be linked to a criminal activity. Systematic reporting is typically limited to one or more of the following:

- any transaction involving cash or other negotiable/bearer instruments in excess of a particular amount;
- cross-border transactions involving bearer instruments in excess of a particular amount;
- and cross-border electronic transactions of any amount.

6. Selective reporting is made based on the judgment of the person covered by the transaction reporting requirement that the transaction could be linked to a criminal activity. Typically, the selective reporting requirements placed on regulated financial institutions are more rigorous than those placed on others.

7. There is no single model for the organizational structure of FIUs: they can be independent bodies, or offices within a financial supervisory body, or an interagency unit coordinated by a government department such as the Prime Minister's Office, the Ministry of Justice, the Prosecutor's Office, or the Ministry of Finance.

8. Because money laundering, terrorism finance, and international fraud often involve numerous jurisdictions, the sharing of financial information among FIUs is an essential element of their operation. Such information can be requested by an FIU if it has reason to believe that another has information or intelligence of relevance, and can also be shared without request if an FIU believes that it has information of relevance to another. Because much of the work of FIUs involves gleaning intelligence from an the analysis of patterns of transactions, the broader the geographic scope of transactions examined the more effective will be the analysis.

9. Because the information handled by FIUs can be of a highly confidential nature, the protection of human rights requires that strict rules of confidentiality be observed. It is also essential that confidentiality be maintained when information is shared among jurisdictions. However, even if a foreign FIU, law enforcement or regulatory body keeps the information confidential, they could still act in other ways that violate human rights. For this reason, a more comprehensive examination must be made of potential foreign recipients of financial information. So far, standards on the conditions under which information can be shared have been established through bilateral agreements. The Egmont Group of FIUs has drafted model bilateral memoranda of agreement with respect to information sharing that covers these issues. There is a trend towards greater regional cooperation in the European Union, the Caribbean and the Pacific Islands region, but there is not yet any global multilateral framework in place.

10. At least with respect to participating jurisdictions, problems of sharing information would be obviated in those instances a single FIU serves more than one country. While it is typical for a country to have its own FIU, recent proposals have been made to create regional

FIUs in both the Caribbean and Pacific Islands regions. It has been proposed that these regional FIUs also set and possibly assess standards for the implementation of AML measures in their members (including with respect to confidentiality and the use of information), and that they assist members with lesser developed infrastructure resources in implementing those standards. The role of such proposed regional FIUs could in theory be escalated to a super-regional or even global level.

ELEMENTS OF AN ANTI-MONEY LAUNDERING QUESTIONNAIRE

1. The AML questionnaire would inquire about the laws, regulations, institutions and policies in place to deter money laundering and terrorist financing in the context of financial supervision. In lieu of answering the questionnaire, members could refer to recently completed self or mutual evaluations carried out in the context of FATF or FATF-style regional body evaluations, or in the context of FSSAs.
2. The questionnaire could be tailored to the circumstances of the recipient country. Questions at a minimum would include those relating to application of the current version of the Fund and Bank methodology document, which address supervisory and regulatory AML elements. These would relate primarily to laws, regulations or supervisors for financial services businesses with regard to: (i) identifying customers and records retention; (ii) recognizing and reporting of suspicious or unusual transactions; and, (iii) cooperating with relevant authorities in investigations, including by providing customer and transaction information.
3. The questionnaire could be expanded to provide more coverage of legal and institutional issues found in FATF 40 Recommendations not relating to law enforcement, as well as incorporating parts of the anti-terrorism recommendations. The questionnaire could inquire about relevant United Nations treaties in effect; what financial institutions and intermediaries are covered; what guidance has been given to these institutions to assist them in complying; the operations of the relevant supervisory and enforcement institutions; and quantitative information on prosecution of money laundering crime. Below is a sample of a questionnaire with the expanded coverage. Questions that address issues outside the coverage of the current AML Methodology Document are marked with an asterisk.

Sample questions

General Legal Framework and Cooperation with International Treaties

- 1) * How does domestic legislation address the risks of money laundering? What legislation underpins the activities in this area of the supervisory and other financial sector authorities? What financial institutions and intermediaries are covered by AML legislation?
- 2) * What steps have been taken to ratify and implement fully the following United Nations conventions and resolutions?
 - (i) 1988 Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (the Vienna Convention);
 - (ii) 1999 Convention for the Suppression of the Financing of Terrorism;
 - (iii) 2000 Convention against Transnational Organized Crime; and,
 - (iv) Security Council Resolution 1373.

- 3) * How does domestic legislation address the risks of the financing of terrorism?

Identifying Customers and Records Retention

- 4) * What standards have the laws, regulations or supervisor set for financial services businesses with regard to knowing the identity of all customers?
- 5) Have Guidance Notes, Code of Conduct or similar instructions in this area been issued to financial institutions? If so by whom? What status do these have under the law?
- 6) What guidance has been issued to financial institutions regarding those records that must be kept on customer identification and individual transactions?
- 7) Is there a requirement on financial institutions that customer information and transaction records be maintained for a minimum period of five years?
- 8) Does the supervisor require financial institutions to appoint a senior officer with explicit responsibility for ensuring that the bank's policies and procedures are in accordance with local anti-money laundering requirements?
- 9) * Under what circumstances can a financial service business take business referred to it without verifying the identity of the ultimate beneficial owner?

Recognizing and Reporting of Suspicious or Unusual Transactions

- 10) What standards have been issued to financial institutions regarding the recognition of potentially suspicious transactions, * including those related to the financing of terrorism?
- 11) When must financial institutions report suspicious transactions to the authorities? (for example, a Financial Intelligence Unit?)
- 12) What mechanisms are in place to ensure that the information is promptly communicated to the relevant supervisor?
- 13) * How many reports have been filed in last two years?

Cooperating with Relevant Authorities in Investigations, including by Providing Customer and Transaction Information

- 14) * What institutions are involved in setting anti-money and anti-terrorism financing laundering laws, rules and guidance? What institutions are involved in monitoring compliance, and in collecting and using information related to suspected or actual criminal activities?

- 15) * How does the supervisor, directly or indirectly, share with the relevant judicial authority and with other domestic and foreign financial sector supervisory authorities information related to suspected or actual criminal activities? Under what conditions?
- 16) What legal powers does the supervisor have to ensure adherence to the jurisdiction's anti-money and anti-terrorism financing laundering laws, rules and guidance? How does the supervisor verify that financial services businesses are complying with them?
- 17) Within the financial sector supervisory agency or agencies, what is the extent of in-house resources with specialist expertise in financial fraud and anti-money laundering obligations?

Quantitative Information on Prosecution of Money Laundering Crime

- 18) * How many prosecutions for money laundering crimes have there been in the past two years and how many have been successful?