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October 23, 2023

2023 REVIEW OF THE FUND'S ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM STRATEGY—BACKGROUND PAPERS

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BACKGROUND PAPER I: MACROECONOMIC IMPACT OF ILLICIT FINANCIAL FLOWS (IFF)

Executive Summary

IFF have received increased attention globally due to their significant adverse effects on the macroeconomies of countries where they originate, transit, and/or are integrated. This background paper takes stock of the efforts to estimate and address cross-border IFF and discusses potential solutions that the Fund could advance to mitigate IFF, highlighting how technology can be leveraged to analyze big data on cross-border payments and prioritize efforts. The paper discusses the economic impact of IFF and how the Fund—although it does not yet have a dedicated policy on IFF—could help address related macroeconomic risks building on its anti-money laundering and combating the financing of terrorism (AML/CFT) strategy and the Framework for Enhanced Engagement on Governance.

A. Addressing IFF[1]

1. In recent years, IFF started attracting increased attention of policymakers, civil society, and international organizations. Relevant work by the United Nations (UN), the World Bank, the Organisation for Economic Co-operation and Development (OECD), national AML/CFT authorities' risk assessments; and typologies of relevant crimes contributed to the growing awareness about IFF adverse effects on tax and broader public financial expenditures and revenues, external and financial sectors' stability, and governance and rule of law. In addition, IFF are often discussed as a barrier to sustainable and inclusive economic growth, benefiting narrow elites and widening inequality, promoting informality, and undermining social cohesion and trust in governments.

2. International organizations and civil society organizations (CSO) have contributed to a multi-pronged global agenda on IFF. The discourse around IFF gained increased prominence in 2015 with the adoption of the Sustainable Development Goals (SDGs), which include tackling of IFF as a target[2] in its recognition as a key disabler of sustainable development. In recent years, IFF have been recognized among significant global economic challenges, as reflected, for instance, by the Group of Twenty (G20) and Group of Seven (G7).[3] International organizations including the World Bank and the OECD have also been active in global efforts against IFF, for instance, through development of methodologies and toolkits on measurement of IFF as well as through analytical and capacity development (CD) support on topics including AML/CFT, anti-corruption, beneficial ownership transparency, stolen assets recovery, among others to strengthen countries' capacity to tackle IFF.

[1] Prepared by Maksym Markevych, Alexander Malden, Adrian Wardzynski, and Indulekha Thomas (all LEG).

[2] SDG 16 on Peace, Justice and Strong Institutions includes addressing IFF as a target in SDG 16.4.

[3] For instance, countries expressed their strong commitment to address IFF in the 2021 and 2019 G20 Declarations. The importance of tackling IFF was also noted in the G7 Leaders' Communiqué in 2022 and 2023.

National and bilateral efforts have also begun to emerge in the fight against IFF. In 2021, the United Kingdom and the United Arab Emirates signed a partnership which focuses on addressing IFF used for terrorist financing (TF) and those resulting from money laundering (ML) in high-risk sectors such as dealers of precious metals and stones, real estate, and virtual assets (VAs).[4] CSOs are also prominently involved in combating IFF through the development of global measures, as well as analytical work and campaigns against proceeds generating crimes (including tax crimes and corruption).[5]

3. Following the 2009 financial crisis, the issue of tax abuse, a key component of IFF, found its way to the top of the global policy agenda. The public interest in this area was further fueled by tax scandals and numerous data leaks. The Financial Action Task Force (FATF) Recommendations recognized serious tax crimes as one of the predicate offenses for ML in 2012. Another major breakthrough was the international tax transparency standards developed throughout the 2010s and their peer review by the OECD Global Forum.[6] It is estimated that progress on transparency and exchange of information helped to identify about €114 billion in additional revenue (tax, interest, penalties).[7] O'Reilly, Ramirez, and Stemmer (2019) further demonstrated that increased international tax transparency led to a decline of about 24 percent (or US$410 billion) between 2008 and 2019 in offshore bank deposits by foreign residents in offshore financial centers (OFCs).[8] Today, international tax abuse, one of the key components of IFF, continues to be the focus of policymakers, supported by the challenging post-pandemic economic outlook with high sovereign debt levels and persistently high inflation.

B. Economic Impact of IFF

Definition

4. There is no internationally accepted definition of IFF, but certain common features or hallmarks can be distinguished among its various definitions. This paper refers to IFF as cross border-financial flows associated with illegal activities in their origin (e.g., results of illegal acts such as corruption), transfer (e.g., conduit tax arrangements), or destination (e.g., funds used for illegal purposes such as TF). This definition excludes legal tax avoidance flows, consistent with approaches

[4] United Kingdom Ministry of Justice, "New landmark partnership with UAE to tackle illicit finance" (London, 2021). https://www.gov.uk/government/news/new-landmark-partnership-with-uae-to-tackle-illicit-finance

[5] Report of the High-Level Panel on IFF from Africa

[6] For a discussion on the relevance of the international tax transparency standards to tackling IFF, see OECD, "Facilitating the Use of Tax-Treaty-Exchanged Information for Non-Tax Purposes: A contribution to a whole-of government approach to tackling illicit financial flows" (Paris, 2023).

[7] Organisation for Economic Cooperation and Development, "OECD Global Forum Annual Report 2022" (Paris, 2022). https://www.oecd.org/tax/transparency/documents/global-forum-annual-report-2022.pdf

[8] Additional analytical work from the Fund—Sebastian Beer et al., "Hidden Treasure: The Impact of Automatic Exchange of Information on Cross-Border Tax Evasion," International Monetary Fund (IMF) Working Paper No. 2019/286 (Washington, 2019). https://www.imf.org/en/Publications/WP/Issues/2019/12/20/Hidden-Treasure-The-Impact-of-Automatic-Exchange-of-Information-on-Cross-Border-Tax-Evasion-48781.

adopted by the OECD[9] and the World Bank.[10] Notably the UN's statistical definition of IFF has a broader scope, including flows that are not strictly illegal (such as tax avoidance flows) as well as exchange of value beyond financial transfers (e.g., illicit cross-border bartering).[11] For the purpose of staff's work on IFF, the narrower definition used by the OECD and the World Bank seems to be more fitting.

5. IFF may have a negative macro-critical effect through a variety of economic channels. The fundamental impact of IFF is undermining the productivity and growth of the economy, as IFF and underlying criminality distort market prices and balance of payments, inhibit genuine investment and effective allocation of resources, eroding the incentive structure of voluntary exchange, embezzle public resources, create volatility not linked to economic fundamentals, as well as weaken cooperation and fair market competition. As an example, tax crimes—one of the main IFF components by value—undermine efficient revenue collection and lead to revenue leakage, while fraud, corruption, and embezzlement lead to misallocation of public expenditure and lower productivity. Furthermore, organized crime, drug trafficking, environmental crimes, and their proceeds could deepen the informality of the economy, distort markets, weaken trust in the government and institutions and rule of law, and affect climate change.

6. Economic and other indirect benefits from IFF can be enjoyed—at least in the short and medium term—by international financial centers (IFCs) focusing on global provision of banking and professional services, which however entail risk of facilitating IFF. Financial centers attract inflows for many legal reasons, including a well-developed financial sector, infrastructure, an educated population, strict adherence to the rule of law, and lack of corruption. At the same time, mixed in with legal flows, IFF can distort normal economic activity. For example, IFF can create "hot money" in the banking sector and/or asset bubbles and push out regular real estate buyers and make the government overly dependent on fees connected to IFF (e.g., fees charged under the citizenship or residency by investment programs), and certain taxes (e.g., higher employment tax and value-added tax yields).

7. IFCs are drawn to gaining a short-term competitive edge through attractive tax, and secrecy and data protection regimes. The more immediate economic benefits, as noted above, often outweigh the less apparent longer-term-risks relating to the balance of payments instability or broader financial integrity of the financial system and the inclusive and sustainable growth in the economy. Such IFCs design tax regimes geared toward non-residents, including citizenship by investment schemes, and offer favorable, or zero tax rates coupled with increased financial secrecy and excessive data protection, and limited international cooperation. All this provides an attractive environment to hide illicit funds and wealth. The international tax transparency standards helped to provide for increased cross-border transparency to tackle tax evasion. The ongoing reforms of the

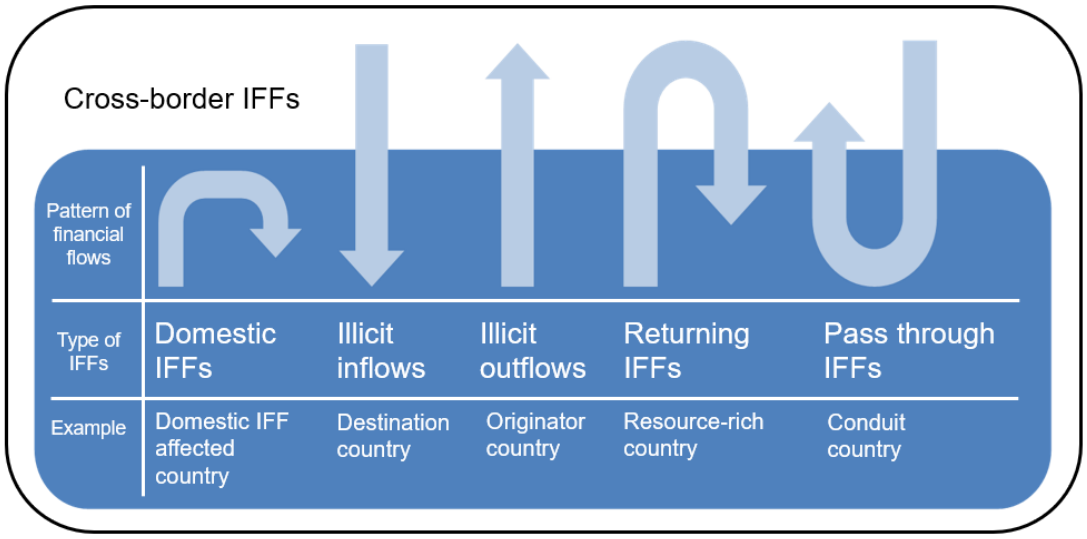
[9] OECD, "Assessing Tax Compliance and IFF in South Africa 2022" (Paris, 2022).

[10] World Bank, "Board Update on Domestic Resource Mobilization and IFF" (Washington, 2017).

[11] United Nations Conference on Trade and Development (UNCTAD)—United Nations Office on Drugs and Crime (UNODC) Statistical Task Force, "Conceptual Framework for the Statistical Measurement of IFF" (2022).

international tax architecture, such as the Global Minimum Tax envisaged under the OECD Project, could help rein in a "race to the bottom" on tax rates.[12]

Figure I.1. Modalities of IFF



Originator Countries

8. IFF outflows negatively impact the macroeconomy of the originator country through impeding domestic revenue mobilization and public and private investment. The majority of global IFF originate from low-income countries (LIC) and fragile and conflict-affected states (FCS),[13] hindering domestic revenue mobilization, which in turn affects these jurisdictions' ability to address their development challenges and to reduce their dependency on aid. Putting in place measures to mitigate risks of domestic laundering of proceeds of crimes and reduce IFF outflows can increase a country's domestic revenue mobilization from taxes, especially those generated from goods and services. Significant illicit outflows can also distort originator countries fiscal position, asset prices, and reduce foreign reserves, resulting in significant development challenges. The impacts of IFF outflows are particularly acute in resource-rich and low-income FCS, which often face severe governance vulnerabilities and corruption, and IFF challenges that can stifle economic growth and development. Furthermore, illicit outflows have been found to have a strong negative effect on public and private investment rates[14] in a country, depriving it of domestic resources required to foster robust long-term sustainable and inclusive economic growth needed to help reduce poverty.[15] The African

[12] See https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm.

[13] Kasper Brandt, "Illicit financial flows and developing countries: A review of methods and evidence," *Journal of economic surveys* (2022). https://doi.org/10.1111/joes.12518

[14] J.D. Nkurunziza, "Illicit Financial Flows: A Constraint on Poverty Reduction in Africa," *Association Of Concerned Africa Scholars Bulletin,* 87 (2012).

[15] Marc Herkenrath,"Illicit Financial Flows and their Developmental Impacts" (2014).

Development Bank (AfDB) noted that in Nigeria and Angola, for example, preventing IFF could have resulted in additional investment of US$10.7 billion and US$3.6 billion per year, respectively, in the period 2000 to 2008.[16] According to this study, had illicit outflows from Africa been invested efficiently, their economic impact could have reduced the poverty ratio for the continent by an additional 4 to 6 percentage points.[17]

9. Resource-rich FCS are often most heavily impacted by illicit outflows. These countries face significant governance, corruption, and IFF challenges that can stifle economic growth and development. In sub-Saharan Africa and the Middle East, countries with a high share of oil and petroleum products in their total exports have been found to have higher levels of IFF.[18] The high-value, complex value chains and transnational ownership structures, high-level of discretionary political control, and difficultly of monitoring outputs within the extractives industries make the sector high-risk for significant IFF, through corruption, trade mis-invoicing (i.e., trade based money laundering (TBML)), and tax evasion. The heightened IFF from resource-rich countries impede the ability to use the resource revenues resulting from the extractive industries to support the development priorities of the country. In order to address IFF more effectively in the extractives sector, efforts have been made to produce official data on the size of IFF, including a pilot project aiming to identify the IFF through gold exports in Burkina Faso.[19]

Transit Countries

10. IFF can result in short-term economic benefits for transit countries but present also longer-term negative consequences risks. As outlined above, IFCs or smaller offshore centers may benefit from attracting IFF inflows through offering favorable tax regimes and quality professional services (neither of which are illicit), and financial secrecy and overly restrictive data protection rules (which are not in line with international standards). (See Box I.1 which discusses the role of OFCs and IFCs in facilitating IFFs). However, these transit countries can face longer-term economic impacts as they face pressures from countries and multilateral institutions to minimize global negative externalities of facilitating transit of IFF, notably if it is established that their system is not in compliance with international norms. Countries that pose risks to the international financial system, including those that are placed on the FATF grey list or the European Commission's list of high-risk third countries, can face correspondent banking pressures, and increasing cost of payments critically on remittances. Being listed as a ML/TF high-risk country can impact a country's cross-border trade

[16] AfDB, OECD, United Nations Development Programme, and United Nations Economic Commission for Africa, "African Economic Outlook 2012" (Paris: OECD, 2012).

[17] Landry Signé, Mariama Sow, and Payce Madden, "Illicit Financial Flows in Africa: Drivers, destinations, and policy options," *AFRICA GROWTH INITIATIVE 2020* (2020). https://www.brookings.edu/articles/illicit-financial-flows-in-africa-drivers-destinations-and-policy-options/

[18] Natural Resources Governance Institute, "Resource Governance Index 2021" (New York, 2021). https://resourcegovernanceindex.org/publications-data

[19] UNCTAD, "First-ever official data on illicit financial flows now available" (Geneva, 2023). https://unctad.org/news/first-ever-official-data-illicit-financial-flows-now-available

and have a significant reduction in capital inflows. Grey-listed countries can also face reductions in access to development assistance.

Destination Countries

11. The country where the IFF are integrated into the legitimate economy can also be negatively impacted, although the impact on these countries is less well understood and more difficult to measure. IFF destination countries can face distortion of the sectors targeted for integration of the criminal proceeds, notably banking and real estate, but often face bubbles and busts and reputational risks when scandals erupt. For example, Canada's 2018 Article IV (AIV) consultation covered ML through the real estate sector and the country's latest ML risk assessment acknowledges that illicit foreign funds have been used to purchase Canadian real estate.[20] The United States Strategy on Countering Corruption recognized that illicit actors take advantage of the vulnerabilities in the United States and in the international financial system more broadly to conceal their illicit proceeds, noting, for instance, that the U.S. real estate market had become a significant destination for the integration of proceeds of illicit activity.[21] The strategy highlighted the need to address gaps in the domestic AML frameworks to curb illicit finance. Similarly, in the United Kingdom, a report by Transparency International indicated that £4.2 billion worth of property owned in London has been bought by individuals and companies representing a high ML risk.[22] The U.K.'s Foreign Affairs Committee assessed the impacts of illicit finance on the United Kingdom following the additional attention brought to the issue by the initiation of the war in Ukraine. The Committee noted that the United Kingdom's role as a global financial center is damaged by its reputation as a destination for illicit finance and that the inflow of illicit flows can have consequences for the country's national security and integrity of its institutions.[23] Strong institutions and proper regulations coupled with effective AML/CFT frameworks can help minimize the macroeconomic impact on the integrity of the financial sector and the broader economy, and assist those countries to detect and disrupt those activities and recover the ill-gotten proceeds to the country of origin. Efforts to prosecute the perpetrators of financial crimes, confiscate and recover the ill-gotten proceeds are becoming more effective in countries of destination but they are still not commensurate with the size of laundered

[20] A survey of real estate advisors in Canada showed that plurality of real estate advisors reported purchase by foreigners of 25 percent or more of luxury properties (Royal LePage, "One in Four Real Estate Advisors Believe that 25 Per Cent or More of Luxury Properties Are Purchased by Foreign Buyers" (2016). https://www.royallepage.ca/en/realestate/news/one-in-four-real-estate-advisors-believe-that-25-per-cent-or-more-of-luxury-properties-are-purchased-by-foreign-buyers/). Risk assessment available at: Department of Finance Canada, "Updated Assessment of Inherent Risks of Money Laundering and Terrorist Financing in Canada" (2023). Updated Assessment of Inherent Risks of Money Laundering and Terrorist Financing in Canada

[21] White house, "United States Strategy on Countering Corruption" (2020), https://www.whitehouse.gov/wp-content/uploads/2021/12/United-States-Strategy-on-Countering-Corruption.pdf.

[22] Transparency International United Kingdom and Thompson Reuters, "London property: A top destination for money launderers" (London, 2023). https://www.thomsonreuters.com/en/press-releases/2016/december/foreign-ownership-of-london-property-shrouded-in-secrecy.html

[23] The Foreign Affairs Committee, "The cost of complacency: illicit finance and the war in Ukraine," Second Report of Session 2022–23 (2023). https://publications.parliament.uk/pa/cm5803/cmselect/cmfaff/688/report.html

proceeds.[24] This is partly due to the fact that the proceeds are already layered and far from the country of origin where the underlying crimes were committed which make the detection more difficult and the negative impact on the macroeconomy more diffuse, but also because destination countries are often focused on proceeds of crimes produced domestically and less so on cross-border financial flows from other countries. Finally, professional enablers (e.g., lawyers, accountants, real estate agents) continue to play an important role in facilitating IFF, notably when effective AML/CFT regulations and implementation are significantly lacking (Box I.1).

Box I.1. OFCs and IFCs and the Role of Professional Enablers

The role of OFCs and IFCs are critical puzzle pieces in any discourse on IFF. In its simplest form, an OFC is a jurisdiction where the bulk of financial sector activity is offshore.[1] The broad scope entails significant diversity in the types of jurisdictions that could be categorized as OFCs, including advanced and emerging economies. The Fund has not maintained a classification of OFCs since 2008, when its OFC program was integrated with the Financial Sector Assessment Program. However, financial centers that exhibit the characteristics of OFCs have unique vulnerabilities to the flow of illicit funds and the creation of companies/trusts that are at risk of misuse for criminal purposes, which merit consideration in discussion of mitigation measures. IFCs, on the other hand, are large international full-service centers with advanced settlement and payments systems, supporting large domestic economies, which have diverse sources and uses of funds. The ill-gotten proceeds are often far from the underlying crimes when they transit or are integrated in other economies. They would have followed many routes of layering which would make the detection and re-establishing the connection to the original crimes more difficult for AML agencies.

OFC and IFCs present significant vulnerabilities to the transit and integration of IFF. Large financial sectors serving non-residents make OFCs and IFCs vulnerable to the passthrough of IFF or their final integration. Characteristics of some OFCs including financial secrecy, relaxed regulatory and tax regimes, and weak financial sector supervision can provide 'efficient routes' for the transit of IFF. IFCs are attractive destinations for IFF due to the size of the financial sector and the stability and strength of their domestic economies. IFCs with weak AML/CFT frameworks can be 'magnets' for IFF, attracting global illicit flows.

In addition to direct IFF routes, OFCs and IFCs may also have well-developed sectors providing 'enabling' services to non-residents, indirectly facilitating the transit and integration of IFF. Many OFCs and IFCs have large sectors providing specialist services to non-residents, including company formation, tax planning, accountancy, and legal services. Some of these sectors (especially lawyers, trust and company service providers, accountants) are identified as 'enablers' or 'gatekeepers' in that they provide services that can allow criminals to legitimize their illicit proceeds and thus gain access to the financial system and legitimate economy. Thus, even where there is no significant direct movement of IFF through these jurisdictions, the presence of large and underregulated gatekeeping sectors can indirectly facilitate IFF through the use of these services to legitimize illicit funds.

[1] This includes centers where counterparties of the majority of financial institutions' liabilities and assets are non-residents, where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents.

[24] Greater emphasis on implementation of a risk-based approach in the fifth round of FATF's AML/CFT assessments could enhance attention on measures to mitigate risks of integration of IFFs in the destination countries.

Box I.1. OFCs and IFCs and the Role of Professional Enablers (Concluded)

Weak AML/CFT frameworks in OFCs and IFC have negative spillovers for global financial stability. Weak AML/CFT preventive controls and deficiencies in risk-based supervision in the financial sector in OFCs and IFCs can provide established pathways and preferred habitats for IFF. Weak AML/CFT frameworks for enablers can allow their abuse by illicit actors to legitimize illicit funds, indirectly helping the movement of illicit flows. These weaknesses thus have negative externalities for the rest of the world: they undermine other countries' AML/CFT mitigation efforts by facilitating the flow and integration of illicit proceeds.

Global coordination actions would be key in addressing the role of OFCs and IFCs in enabling IFF. The provision of services to non-residents through oversized sectors (financial or specialist services) may be significant contributors to domestic GDP. Strengthening AML/CFT frameworks—for instance, through more intensive supervision of banks and related (incoming) cross-border flows and gatekeepers or increased transparency on beneficial owners of legal entities—may undermine the competitiveness of sectors seeking to attract non-resident activity, affecting the size of the financial sector and its liquidity, fiscal revenue, and growth. The medium-term impacts (including undue emphasis on the financial sector and adjacent services and the sidelining of other productive sectors) as well as their negative externalities for global integrity and stability remain understudied and under-accounted. To address those issues, the next round of FATF assessments could focus further on materiality and spillovers across jurisdictions resulting from those vulnerabilities. Furthermore, the Fund could highlight those vulnerabilities in FSAPs and both bilateral and multilateral surveillance of OFCs and IFCs, as necessary.

Other IFF Trends and Emerging Issues

12. The AML framework is currently underutilized in the fight against tax crimes and to improve tax compliance, and vice versa. While AML measures have already been deployed to improve tax compliance, including during the European debt crisis, the benefits that such measures could bring to the integrity of the tax system are yet to be fully realized, as set out in a recent working paper.[25] Notably, tax enforcement laws are equally useful in the fight against ML, including to support efforts to strengthen asset recovery frameworks.

13. TBML is another central way IFF are transferred, beyond all other regular channels for moving value. TBML refers to the process of disguising the proceeds of crime and moving value using trade transactions in an attempt to legitimize their illegal origins or finance their activities.[26] TBML occurs through the misrepresentation of the price, quantity, or quality of goods and services resulting on the movement of overvalued cross-border transactions. This can be conducted through over or under invoicing or shipment of goods and services, multiple invoicing of the same goods and services, or through falsely describing the nature or value of goods and services. The financial impact of TBML has been estimated as close to US$9 trillion in losses between 2008 and 2017 in developing

[25] IMF Working Paper advocates leveraging AML measures to enhance tax compliance, tackle tax crimes, and, in turn, help mobilize domestic revenues. See Emmanuel Mathias and Adrian Wardzynski, "Leveraging Anti-money Laundering Measures to Improve Tax Compliance and Help Mobilize Domestic Revenues," IMF Working Paper No. 2023/083 (Washington, 2023).

[26] Financial Action Task Force, "Best Practices on Trade-Based Money Laundering" (Paris, 2008). https://www.fatf-gafi.org/en/publications/Fatfrecommendations/Bestpracticesontradebasedmoneylaundering.html

countries.[27] TBML can also provide unfair access to foreign currency in times of economic crisis. Importers could over-invoice the value of imported essential goods and services, so they get privileged access to scarce foreign currency held by the central bank, banks, and foreign exchange offices. When those trends become the norm for importers, such mis-invoicing could lead to foreign exchange (FX) shortages and manipulation of the FX and large spreads on the black market. The United States Financial Crimes Enforcement Network (FinCEN) also identified TBML as a vehicle for laundering significant illicit proceeds, including those resulting from drug trafficking and transnational organized crime.[28]

14. Although the key risks of IFF remain through the banking and broader financial sector, an additional emerging risk is the vulnerability of VAs to be exploited for IFF. While efforts have been made to introduce greater supervision and regulation of VAs, their high inherent ML/TF vulnerability, the uneven implementation AML/CFT measures by virtual asset service providers (VASPs), as well as regulatory arbitrage possibilities create opportunities for abuse of VAs.[29] Criminals may choose to use VAs to transfer illicit funds due to availability of anonymous transactions with limited traceability and an opportunity to transfer value outside the formal banking system, potentially lowering the risk of being detected by financial institutions through the reporting of suspicious activities or by law enforcement authorities through their investigations.

Measurement

15. Several methodologies have been developed to measure IFF at the global and national levels. Measurement efforts were spurred, in part, by the adoption of the 2030 SDG, which includes a target on the reduction of IFF,[30] and calls for the measurement of global values on IFF.[31] Since then, UN agencies such as the UNCTAD and UNODC have developed a conceptual understanding and guidelines for the measurement of IFF, which have now been piloted in nine countries. This pilot program aims at identifying IFF on a sectorial basis. In certain pilot countries, this sectorial approach is focused on sectors of economic significance, including, for example, a program dedicated to estimating IFF in the precious metals and stones and electrical machinery and equipment sectors in South Africa. The hidden nature of IFF necessitates indirect approaches to measurement. Common methodologies include TBML mis-invoicing typologies (i.e., assessing the discrepancies between reported and true values of traded goods and services), capital account models (i.e., calculating capital accounts anomalies from IFF), offshore wealth models (i.e., deriving IFF from calculation of stock of

[27] World Economic Forum, "How trade-based money laundering works and its impact on world finances" (Geneva, 2021).https://www.weforum.org/agenda/2021/06/trade-based-money-laundering/

[28] FinCEN, "Update on U.S. Currency Restrictions in Mexico: Funnel Accounts and TBML" (Washington, 2014). https://www.fincen.gov/resources/advisories/fincen-advisory-fin-2014-a005

[29] Vitalii Rysin and Maria Rysin, "Vulnerability of Virtual Assets to Illicit Financial Flows", *Economics, Entrepreneurship, Management. 2021,* Volume 8, Number 1, pp. 35–42 (Lviv, Ukraine, 2021). Vulnerability of Virtual Assets to Illicit Financial Flows | Academic Journals and Conferences (lpnu.ua)

[30] Target 16.4 calls for the significant reduction of illicit financial and arms flows, strengthening of the recovery and return of stolen assets, and combating of all forms of organized crime.

[31] Indicator 16.4.1 is set as the total value of inward and outward IFF in U.S. dollars.

undeclared wealth in low-tax jurisdictions), tax gap models (i.e., based on the assessment of difference between potential and actual tax collection), and integrated IFF measures[32] (i.e., combining several models to increase accuracy).[33] A survey of existing measurement techniques by the UNCTAD/UNODC IFF Task Force broadly categorizes existing efforts into top-down and bottom-up approaches.[34] The former comprises models based on inconsistencies in aggregated macroeconomic datasets, while the latter estimates IFF from relevant illicit activities (by IFF source) and aggregates these values to arrive at overall estimates. Top-down approaches have thus far been more prevalent, with common measurement techniques including estimates derived from discrepancies in imports and export statistics (mirror trade statistics) and net errors and omissions in balance of payment statistics (hot money method).[35]

16. However, by nature, IFF present serious challenges to measurement, as highlighted by the wide range in existing estimates of IFF. Challenges stem from the temporality of IFF (illegality arising in different stages of the life cycle of the flows) and difficulty establishing linkages between the IFF and the underlying criminal activity. In particular, top-down approaches are hindered by the limited comparability for macroeconomic indicators due to variations in legal and statistical frameworks across jurisdictions and the challenges in distinguishing IFF from measurement inconsistencies. These limitations in measurement manifest in a significantly wide range in estimates of IFF and potentially inflated and misleading estimations of IFF.

17. The challenges in measurement signal the need for a shift towards bottom-up methods for measurement of IFF supported by national strategies. Micro-data for the measurement of IFF are held at the national level, albeit by a range of agencies, including customs, tax, law enforcement, and central banks, among others. National approaches to the measurement of IFF allow the tailoring of measurement to the data specifically available at national/sectoral levels. Recent efforts at developing measurements of IFF have put forth bottom-up measures, particularly to leverage micro-data held by national authorities: For instance, a recent pilot by South Africa with the OECD measured taxpayer data to estimate the stock of non-tax compliant assets held in IFCs and link them to preceding IFF.[36]

[32] UNCTAD, "Methodological Guidelines to Measure Tax and Commercial Illicit Financial Flows" *(published draft for pilot testing)* (Geneva, 2021).

[33] In a 2019 Evaluation of existing models for estimation of IFF, Nicolaou-Manias categorizes prevalent models as trade mispricing estimates; shadow economy—tax gap models; capital and wealth models; international tax avoidance models; risk-based models; integrated IFF models; and artificial intelligence (AI) and machine learning models. See Kathy Nicolaou-Manias, "Supplementary Report: Review of Existing Indicators for Illicit Financial Flows and Possible Alternative Indicators for African Countries" (2018).

[34] UNCTAD-UNODC Statistical Task Force, "Conceptual Framework for the Statistical Measurement of Illicit Financial Flows".

[35] A widely cited top-down measurement of IFF is one used by Global Financial Integrity which aggregates the results from two different methods, i.e., using global trade statistics and balance of payment statistics respectively to derive a total estimate of total IFF.

[36] OECD, "Assessing Tax Compliance and Illicit Financial Flows in South Africa."

C. Addressing IFF and the Role of the Fund

18. The AML/CFT international standards provide important tools to tackle IFF. Effective implementation of the FATF Standards has been fundamental to strengthening countries' domestic measures against ML/TF, with particular focus on the risk-based approach as required by the standard. As the FATF focuses on the effectiveness of AML/CFT frameworks to tackle ML/TF, it would be important for staff to continue to focus on the impact of ML/TF and IFF on the broader macroeconomic outcomes, such as fiscal performance, financial and external sector stability, economic growth, and its sustainability and inclusivity.

19. Some issues related to countering of IFF are currently covered under the Fund's policies on AML/CFT and on Governance. IFF can have macro-critical impacts in origin, transit, and destination countries across various dimensions of the Fund's work as described above. In addition, as IFF cross borders to lower the probability of detection, asset tracing, and confiscation (e.g., regulatory arbitrage to utilize jurisdictions with the least effective AML/CFT regimes), they have a global dimension and are inextricably linked to global financial integrity and stability. Of high relevance to the Fund's mandate,[37] IFF can lead to unstable exchange rates delinked from the economic fundamentals, imbalanced growth of international trade due to the distorting impact of TBML, as quantity and direction of goods traded is dictated by ML/TF typologies rather than business rationale. In addition, ML/TF concerns undermine trust in the global system of payments, leading to pressures on correspondent banking relationships (CBRs).

20. Staff developed a machine learning algorithm to monitor global cross-border payments to detect unusual and potentially suspicious patterns of financial flows. ML is a covert activity, and ML risks are difficult to identify and assess at the national level, especially when cross-border risks need to be considered. Historically, the Fund's engagement has been mostly externally driven, based on countries' mutual AML/CFT evaluations and other relevant assessments (e.g., OECD Global Forum, UNCAC), listing by the FATF and others, law enforcement actions and public information, which is mostly qualitative. The Fund's access to cross-border payments data provides an important financial integrity tool for staff's work. It allows for the analysis of financial flows patterns, identification of financial flows that are not explained by economic fundamentals (e.g., foreign trade in goods and services, portfolio, and direct investments) and exploring links with higher ML risk jurisdictions. An outlier detection machine learning algorithm relying on "big data" is being employed for financial integrity screening of cross-border financial flows and identification of lower and higher ML risk jurisdictions. The financial flows analysis toolkit is being used to prioritize AML/CFT-related surveillance engagement for a more data-driven and risk-based identification of jurisdictions where financial integrity concerns could be macro-critical. Staff's analysis of financial flows from a financial

[37] The purposes of the Fund include: (i) to promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems; and (ii) to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy. The full list of purposes of the Fund are set out in Article 1 of the Fund's Articles of Agreement.

integrity standpoint is intended to provide countries with early warnings regarding elevated risks of systemic ML, possible macro-critical financial sector frauds, corruption events, pressures on CBRs. or evolving tax crimes corridors. The objective of the early warnings is to make the Fund's financial integrity engagement with its members more proactive, providing a detailed understanding of possible macro-critical risks that countries are facing, potentially allowing them to address emerging financial integrity issues much earlier, to limit economic damages.

Box I.2. Use of Financial Flows Analysis for AML in the Fund's Workstreams

The results of staff's toolkit for financial integrity screening of cross-border payments are being increasingly incorporated in all the Fund's workstreams, and have informed the analysis and policy recommendations in:

Financial Sector Assessment Programs (FSAPs): FSAPs (AML/CFT Technical Notes) for the United Kingdom (2022) and Ireland (2022).

Surveillance: AIV for Curacao (2021), Singapore (2022), Malta (2023), Cyprus (2023), Lithuania (2022).

Use of Fund resources: Extended Fund Facilities for Moldova, Lebanon, and Armenia.

CD: Nordic-Baltic Constituency AML Project (self-funded); LEG Thematic IFF CD project.

Selected key recommendations and policy advice:

Deepen understanding of ML/TF higher-risk countries and payment patterns based on country specific risk factors and focus on the countries with the most material cross-border financial flows—Nordic-Baltic AML CD Report (2023)

Further improve breadth and depth of risk-based AML/CFT supervision through enhanced data collection, leveraging technology analytical tools (e.g., big data and machine learning)—United Kingdom FSAP (2022)

AML/CFT national policy and institutions should prioritize tackling ML/TF risks related to cross border and non-resident activity—Ireland FSAP (2022)

Develop a national mechanism for monitoring macro-trends in cross-border financial flows—Lithuania Selected Issues Paper (2022)

21. The Fund's well-developed CD thematic work programs are directly relevant to combatting IFF. A multi-country thematic project on addressing IFF, leveraging staff's machine learning toolkit was launched with the support of the Fund's AML/CFT Thematic Fund in 2023, The CD project is intended to help members monitor cross-border wire transfers and strengthen AML effectiveness in mitigating cross-border ML risks. In addition, Fund's CD engagement has also covered topics directly relevant to the measurement and combatting of IFF, including projects on assessment of cross border ML risks, supervisory strategies to mitigate ML risks, asset recovery, improving tax compliance, enforcement frameworks, and international cooperation and exchange of tax information,[38] among others. On measurement and estimation of IFF, the Fund has elaborated on accounting for illegal activity and IFF in its guidance on fiscal and external sector statistics. For instance, the Fund's proposed framework for measuring the informal economy *inter alia* notes that some forms of illicit activity undertaken in the informal sector should be accounted for in the

[38] More work, including CD assistance, is needed to reap the benefits from exchange of information especially for developing countries. IMF Fiscal Monitor (April 2022) shows that many developing countries (also members of the Global Forum) are not receiving information.

estimation of the informal economy.[39] Statistics compiled by the Fund, for instance, are also widely used as the dataset in top-down estimations of IFF.[40] Fund's work to strengthen members' governance and enhance anti-corruption measures can be impactful in addressing a variety of economic crimes, preventing IFF at the source.

22. Empowering AML regimes with a greater understanding of risks arising from IFF could also improve tax compliance and help mobilize domestic revenues. Well-designed AML measures could be leveraged for the purposes of tax administration. The AML measures that could be helpful in relation to ensuring tax compliance are the following: (i) greater utilization of customer due diligence (CDD) and transaction monitoring data that can help identify taxpayers, their taxable income, wealth, and assets; (ii) closer inter-agency cooperation and sharing of information between AML and tax authorities, including information available through the various statutory filings made by entities subject to the AML control regime that can support the detection of tax crimes, help assess risks of tax non-compliance, better target tax audits, and contribute to taxpayer risk profiling; (iii) recourse to enforcement tools available under the AML regime that could complement those already available to the authorities responsible for the pursuance of tax crimes, including through parallel ML and tax crime investigations and extending of the accountability framework to accomplices and complicit service providers; and (iv) increase in the overall deterrence effect resulting from the greater transparency, cooperation, and coordination, as well as the threat of potentially higher sanctions arising under the AML laws.

23. Strong beneficial ownership transparency frameworks can also help address the abuse of legal entities for IFF. Notwithstanding the obligation of financial institutions and designated non-financial business professions (DNFBPs) under the FATF standard to identify beneficial owners of their clients, the use of companies and trusts as a vehicle to move illicit funds is likely a significant driver of IFF, with an estimated almost 40 percent of all foreign direct investment passing through empty corporate shells associated with no actual economic activity.[41] Several countries, including the United Kingdom and Canada have looked at strengthening beneficial ownership transparency to prevent the use of shell companies to purchase real estate using illicit funds. The FATF Standards for transparency of beneficial ownership of legal persons and arrangements (Recommendations 24 and 25) were recently revised, requiring member countries to ensure accurate, adequate and up-to-date beneficial ownership information is available to all relevant competent authorities. Supporting the development of these frameworks can ensure that member countries are able to better detect and counter the use of legal structures to move IFF or integrating them into the legitimate economy. The Fund has also

[39] Gabriel Quiros-Romero et al., "Measuring the Informal Economy," IMF Policy Paper No. 2021/002 (Washington, 2021). Measurement of the informal economy under discussion as part of the update of the System of National Accounts 2008 and the sixth edition of the Balance of Payments and International Investment Position Manual. This includes, in particular, the establishment of the joint informal economy task team to aid the development of statistical standards to conceptually and operationally define concepts to measure work and economic activity, including cross-border transactions, in the informal economy. See Joint Task Team on Informal Economy: Terms of Reference.

[40] IMF's Direction of Trade Statistics, Balance of Payment Statistics, Coordinated Direct Investment Survey, Coordinated Portfolio Investment Survey, International Financial Statistics, and International Investment Position Statistics are among those serving as datasets used in common IFF estimation methodologies.

[41] Jannick Damgaard et al., "Piercing the Veil," IMF Finance & Development. Vol 55, Issue 002 (Washington, 2018).

called for the implementation of beneficial ownership registers as a measure to enhance tax compliance.[42]

D. Way Forward

24. The Fund is well positioned to focus on the macroeconomic impact of spillovers arising from disparities and weaknesses in AML/CFT regimes across jurisdictions. Inefficient AML/CFT measures in one jurisdiction can attract illicit flows and create safe havens for the perpetrators of crimes. Considering the importance of cross-border activity for ML/TF, a risk-based approach to AML/CFT focused on IFF and macroeconomic impact calls for stronger focus on jurisdictions that play an important role in facilitating the channeling and integration of IFF in the international financial system.

25. The Fund could work closely with the UN, World Bank and other international bodies engaged in this area while focusing on its comparative advantage related to macroeconomic impact of IFF. While this paper focuses on the AML toolkit in tackling IFF, staff's broader expertise on fiscal (e.g., tax policy), monetary, financial, and structural reforms could allow an interdepartmental integrated and multidisciplinary approach in developing better measurement and mitigating measures to limit the impact of IFF on both domestic and international levels (e.g., spillovers).

26. The Fund's near universal membership puts it in a unique position to engage with member countries on issues related to IFF. The Fund undertakes regular economic surveillance of its 190 member countries, with periodic in-depth analysis into the stability of members' financial sectors through its FSAPs. The Fund's broad membership allows it to engage with countries (including source, transit, and integration jurisdictions for IFF), many of which are not within the purview of other international organizations undertaking work related to IFF, such as the OECD.

27. In its multilateral surveillance, the Fund focuses on issues that may affect the effective operation of the international monetary system (IMS), Under the Integrated Surveillance Decision (ISD), an AIV consultation is a vehicle for both bilateral and multilateral surveillance. In AIV consultations, staff could, in particular, discuss outward spillovers arising from a member's policies where the member is not promoting its own domestic or balance of payments stability, or where the spillovers may potentially have an effect on global movement of IFF. Integration of IFF considerations in multilateral surveillance would result in an additional focus on spillovers across jurisdictions, also due to the effects arising from the member's AML/CFT policies on other countries. The potential for abuse of vulnerabilities and loopholes is particularly high in emerging and advanced economies attractive to the integration of criminal proceeds and financial centers specializing on provision of non-resident professional and financial services, as ineffective AML/CFT policies in these countries provide ML opportunities for criminals from other countries.

[42] IMF, "Fiscal Monitor: Fiscal Policy from Pandemic to War" (Washington, 2022).

BACKGROUND PAPER II: AML/CFT RISK-BASED SUPERVISION OF BANKS—THE IMPACT OF FINANCIAL INTEGRITY FAILURES ON FINANCIAL STABILITY

Executive Summary

This background paper explores the impact of ML and related predicate crimes on banking sector stability. The paper identifies potential short- and medium-term impacts of financial integrity failures on individual banks' performance and systemic stability, and outlines a framework piloted by Fund staff for the quantification of such impacts. Finally, the paper puts forth some proposals for deepening the engagement on financial integrity—financial stability nexus through the Fund's core functions.

A. Background[1]

1. ML and its predicate crimes (tax evasion, corruption, drug trafficking, fraud, etc.) can have significant impact on the stability of the financial sector and broader economy.[2] These effects can manifest in jurisdictions where illicit proceeds originate, where they transit, and where they are integrated. Macro-critical impacts of ML and its predicate crimes can be grouped into (i) de-stabilizing effects on the financial sector, (ii) adverse impacts on the broader economy, and (iii) inward and outward spillover effects. The effective operation of a country's financial system depends heavily on trust and the expectation that the highest professional, legal, and ethical standards are observed. Financial and external stability may be undermined by the act of ML or TF itself but also by the associated crimes (i.e., predicate crimes).

2. Failures or weaknesses in countries' AML/CFT regimes and risk-based supervision of banks can threaten financial sector stability.[3] The adverse effects of ML and its predicate crimes are commonly channeled through the banking sector. For instance, volatile inflows/outflows from the injection or withdrawal of large amounts of criminal proceeds from predicate crimes could de-stabilize the banking sector. Regulatory sanctions for financial integrity failures in banks can increase credit, solvency, and liquidity risks, with potential de-risking of the concerned institution in the medium-term which may be transmitted to other banks through interconnectedness of assets and liabilities or contagion effects. Large-scale predicate crimes, such as financial sector frauds, may also cause bank insolvencies, with potential systemic impacts within the sector. Further, assessed or perceived weaknesses in AML/CFT frameworks or perceived high levels of ML and economic crimes within a

[1] Paper prepared by Grace Jackson, Pierre Bardin, Indulekha Thomas (all LEG), and Antoine Bouveret (LEG consultant).

[2] TF usually entails smaller sums and can be largely macro-critical for FCS or states where terrorist groups have control over natural resources. While the focus of the background note is on ML, measures to mitigate ML are often complementary to those that mitigate TF. In these instances, the background note refers to ML/TF or AML/CFT.

[3] Financial stability is defined as the ability of the financial system to facilitate and enhance economic processes, manage risks, and absorb shocks.

jurisdiction can result in curtailed/reduced access to global financial markets, through correspondent banking relationships pressures.[4]

3. A spate of ML scandals in the financial sector during the review period[5] has highlighted the need for increased focus on potential impacts of such failures on systemic stability in the banking sector. These high-profile AML/CFT failings[6] involving banks with significant cross-border activities have led to revocation of banking licenses and termination of CBRs with affected banks (Box II.3). While these events resulted in increased international scrutiny of AML/CFT supervision, there has been limited analysis of the possible effects of such events on systemic soundness in the banking sector. This paper explores the nexus between financial integrity failures and financial stability, to set out proposals to guide the Fund's future work on financial stability implications arising from AML/CFT failings.

B. ML/TF Risks and Vulnerabilities in the Banking Sector

4. Although non-bank institutions and VAs are growing sectors with financial integrity risks, banks continue to be the main gatekeepers of the financial system and are vulnerable to misuse as a conduit to launder illicit proceeds. In the global financial system, banks continue to be the main intermediary through which illicit funds flow. Banks are particularly attractive for criminals to conceal illicit proceeds and are at higher threat for several reasons: they have a global reach domestically and through branches and subsidiaries, high levels and widespread of activity, broad range of products/services such as correspondent banking and trade finance (that present high levels of ML risks), lower cost, combined with their ease of access and speed of transactions.

5. Banks are required to implement AML/CFT systems and controls. In line with the FATF recommendations, banks are required to implement AML/CFT systems and controls in order to prevent ML, underlying crimes, and TF. When AML/CFT preventive measures—such as CDD measures, record keeping, policies and procedures, customer and entity-level ML/TF risk assessments, internal control systems, transaction monitoring and suspicious transaction reporting—are effectively implemented, they could significantly reduce the risk of laundering of proceeds of crimes or TF going through the banking sector. The cost of implementing those compliance measures by banks is often high requiring constant adjustments to evolving risks, technical tools, and financial and well-trained human resources.

6. Given banks' inherent exposure to ML risks, there is a need for the implementation of strong and robust AML/CFT preventive measures and risk management systems. Despite heightened focus (e.g., inclusion of AML/CFT as a key priority in banks' strategies and increased

[4] In an effort to protect their financial sectors, national supervisors, often in response to the FATF/FATF-style regional bodies' (FSRBs) calls for action, are increasingly prohibiting their banks from dealing with financial institutions from countries with actual or perceived weaknesses in their AML/CFT frameworks, or at least, to subject transactions with institutions from such countries to stricter conditions.

[5] The review period corresponds to the period covered by the 2018 AML/CFT strategy review, i.e., 2018–2023.

[6] Referred hereafter as financial integrity events.

compliance costs) on the effectiveness of banks' preventive measures, banks often (wittingly or unwittingly) become vulnerable and a channel for IFF (for example, to conceal the proceeds of fraud, corruption, and tax crimes).

7. In order to ensure that these controls are fit for purpose and operating as designed, effective oversight—i.e., effective AML/CFT risk-based supervision—is required. AML/CFT supervisors are required to ensure that banks properly implement robust AML/CFT preventive measures including effective systems and controls to adequately mitigate risks. Supervisors are required to assess and analyze banks' AML/CFT frameworks and promote and enforce their effectiveness through risk-based supervisory activities.

8. Both banks' AML/CFT systems and controls, and AML/CFT supervisory efforts often fall short and present significant vulnerabilities. Box II.1 below sets out (at country level) FATF's assessment of the effectiveness of preventive measures and AML/CFT supervision. These results indicate—notwithstanding the important efforts made in the last two decades—that in most instances countries (overall) struggle to put in place robust preventive measures and rarely implement effective risk-based AML/CFT supervisory frameworks. In addition, although supervisors are imposing fines and penalties—that have increased in size overall during the last decade—for banks' weak AML/CFT controls, global trends show that regulators continue to face challenges in their governance, resources, and capacity structures, and have vulnerabilities in their AML/CFT functions and in exercising their responsibilities in an effective manner.

9. There are several ways in which ML, related predicate crimes, and TF can undermine the stability of a country's financial system. Overall, three financial stability risk components are important to assess: (i) the threat of domestic and cross-border illegal proceeds layered or integrated in the banking sector (e.g., volume, trends and channels); (ii) vulnerabilities of the banks in preventing those proceeds to be laundered, and the vulnerabilities of the AML supervisors of banks in ensuring compliance; and (iii) impact on financial stability often resulting from the high threats and high vulnerabilities in the banking sector. Specific financial system effects could be related to:

- **Loss of access to global financial markets:** The failure of a member to deal effectively with ML or TF may result in a loss of access of its financial system to global financial markets, with potentially negative consequences for financial stability and the economy as a whole. It is becoming a more frequent practice for national supervisors to prohibit their banks from dealing with financial institutions from countries with weak AML/CFT frameworks, or to at least subject transactions with institutions from such countries to stricter conditions. Even in the absence of specific guidance from the relevant national authorities, financial institutions in some countries may prove reluctant to deal with banks from jurisdictions where ML or TF is a major concern.

- **Destabilizing inflows and outflows:** ML or TF activities may give rise to significant levels of criminal proceeds (e.g., arising from tax crimes or proceeds of corruption) or—hot money—flowing into and out of individual financial institutions in the country in ways that are destabilizing for these institutions. Such inflows or outflows can be either cross-border or domestic in nature and, where transactions in illegal markets or criminal proceeds are significant

in relation to the size of the country's formal sector, these flows can affect the entire financial system.

- **Financial sector fraud**: ML may also be associated with broader problems of financial sector fraud. The potentially adverse effects on financial stability that may arise from large-scale Ponzi schemes in the financial sectors of small island economies have been well-publicized. Financial fraud may undermine a country's financial system in many different ways—through large-scale bank insolvencies that ensue when banks' balance sheets are properly valued, by large outflows of capital from the banking system as the scale of the fraud becomes known, or by the loss of access to international financial markets arising from the deterioration in the jurisdiction's reputation.

- **Deficiencies in financial sector supervision or regulatory capture:** Financial integrity failures may serve as evidence of deeper problems regarding the integrity of a country's framework for financial sector supervision. Where important financial institutions within a country are owned or controlled by criminals with elements of regulatory capture, and weak fit and proper requirements are in place, the authorities may encounter difficulties in supervising these institutions or in identifying and addressing problems before domestic financial stability is undermined. The quality of the overall AML/CFT supervisory framework would entail, among other things, the autonomy of the supervisory agency which could undermine its ability to identify and manage financial integrity risks.

- **TF and economic paralysis:** Incidents of terrorism, and TF may also undermine the stability of a country's financial system—either because of a history of terrorist incidents or through the effect of a single but significant incident. These circumstances may make key sectors of the economy vulnerable to declines in economic activity to the point where the stability of individual banks may be threatened. More broadly, banks that are regarded as serving as a conduit for TF may be subjected to international sanctions or, more generally, may encounter difficulties in finding counterparts with which to deal in ways that undermine their own stability.

- **Tax fraud:** ML may be associated with tax fraud that can undermine financial or macroeconomic activity in important ways.[7] Significant levels of tax fraud may affect the government's revenue stream to a point where its fiscal balance is significantly undermined. By limiting opportunities for the banking system to be used to launder the proceeds of tax evasion, a robust framework of AML/CFT controls can serve as an effective instrument in combating tax evasion.

10. In most cases of ML, these problems will be transmitted through a country's financial system. Criminal proceeds and TF will generally have to be placed within a country's financial system and may either remain there or may be transferred abroad to the financial systems of other countries. However, there are circumstances in which the predicate crimes to which ML or TF relate will have an adverse effect on the stability of the broader economy without necessarily directly involving the financial system. This will particularly be the case in countries with only rudimentary banking systems

[7] Tax crimes are a predicate crime under the revised FATF Standards (they appear in the list of designated categories of offenses in the FATF Glossary).

where illegal transactions are conducted in cash or informality and the proceeds of crime are never introduced into the banking system.

11. When banks fail to prevent ML, there can be significant repercussions that raise financial stability concerns. For example, banks scandals triggered by financial crimes could lead to a bank run and their collapse, sanctions by the domestic and foreign regulators or the judiciary, loss of their CBRs, and criminal prosecutorial actions and/or their resolution and liquidation. In egregious cases, the banking sector as a whole could be affected due to lack of proper AML/CFT supervision and the banking sector failing to ensure that laundering of proceeds of crimes is not taking place at a large scale through the sector.

Box II.1. Compliance with FATF Immediate Outcomes 3 (Effectiveness Ratings on AML/CFT Supervision) and 4 (Effectiveness Ratings on AML/CFT Preventive Measures)

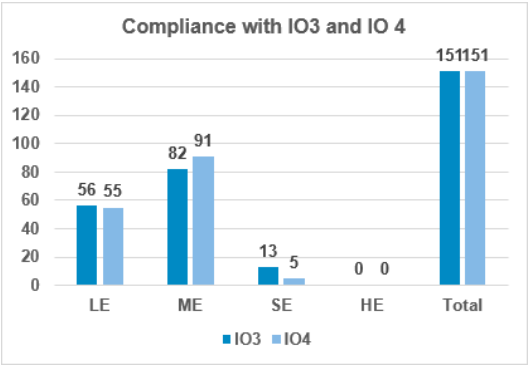
LE= Low Level of Effectiveness

ME = Moderate Level of Effectiveness

SE = Substantial Level of Effectiveness

HE= High Level of Effectiveness

Box Figure 1. Compliance with IO.3 and IO.4



Rating	IO3	IO4
LE	56	55
ME	82	91
SE	13	5
HE	0	0
Total	151	151

12. The central role of banks in the global financial ecosystem, overlayed with the high level of exposure to ML/TF risks means that these institutions and their safeguards require particular attention. This attention spans from the implementation of robust AML/CFT preventive frameworks, effective risk-based supervision, to identify the banks that are most vulnerable and ensuring that measures are in place to protect the financial stability of these banks.

C. AML/CFT Failures and Banking Sector Stability

Financial integrity issues could potentially present risks to financial stability for banks in the short- and medium-term, including through contagion effects.

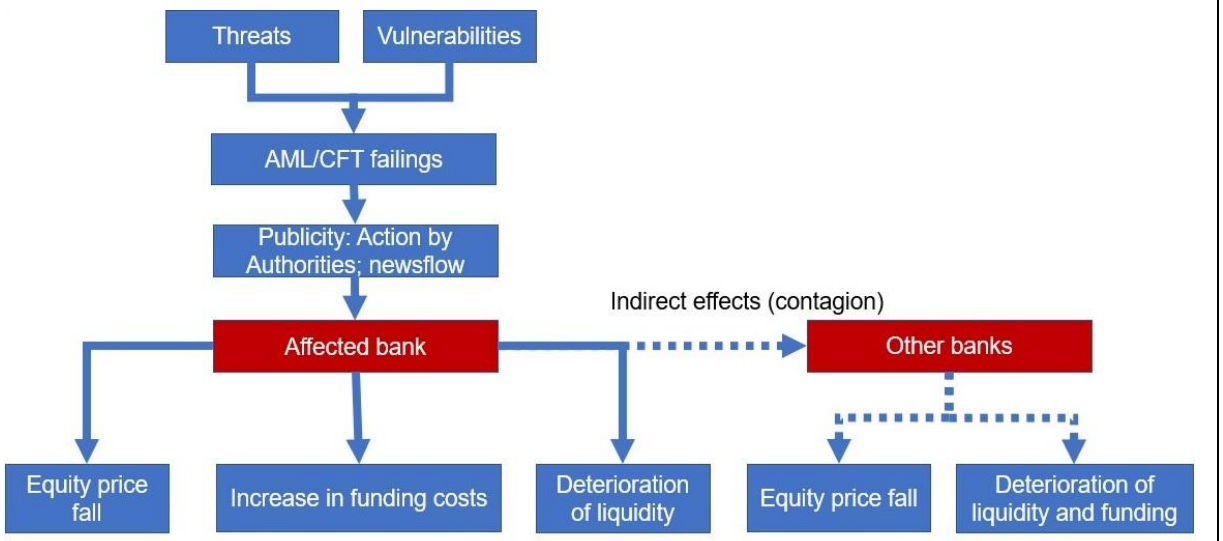
Short-Term Impact

13. In the short-term, banks facing financial integrity issues could face tensions related to wholesale funding and liquidity. In the short term, the impact on the affected bank can crystallize through higher credit risk resulting in higher funding costs (including in foreign currencies), lower liquidity (due to outflows and a possible decline in counterbalancing capacity), higher refinancing risk (due to outflows and a reduction in wholesale funding), and a lower equity price (possibly raising the cost of equity). Stress stemming from entities on a standalone basis could also spread to the financial group, either through direct linkages (such as direct exposures) or indirect effects via reputational effects.[8]

14. Short-term stress affecting one bank could also be potentially transmitted to other banks through direct and indirect effects. Financial integrity issues related to one bank can have an impact on other banks via direct exposures. For example, other banks holding shares in a bank affected by financial integrity issues could face substantial market-to-market losses due to the decline in stock prices for the affected bank. Indirect effects via market confidence could also propagate shocks, especially if other banks have similar exposures and/or comparable business models. Other banks with similar exposures to the affected bank might experience qualitatively similar shocks, as market participants and clients could expect those banks to be facing similar issues. In contrast, banks which are perceived as "safer" might see deposits inflows as clients move away from the affected bank (or similar banks) to other banks. In some cases, high profile ML cases can increase market-based funding costs for all banks, even those with no direct connections to the case at hand. Figure II.1 summarizes the main short-term transmission channels identified.

[8] This transmission channel could also be used when non-bank financial institutions part of a banking group face financial integrity issues.

Figure II.1. Short-Term Transmission Channels

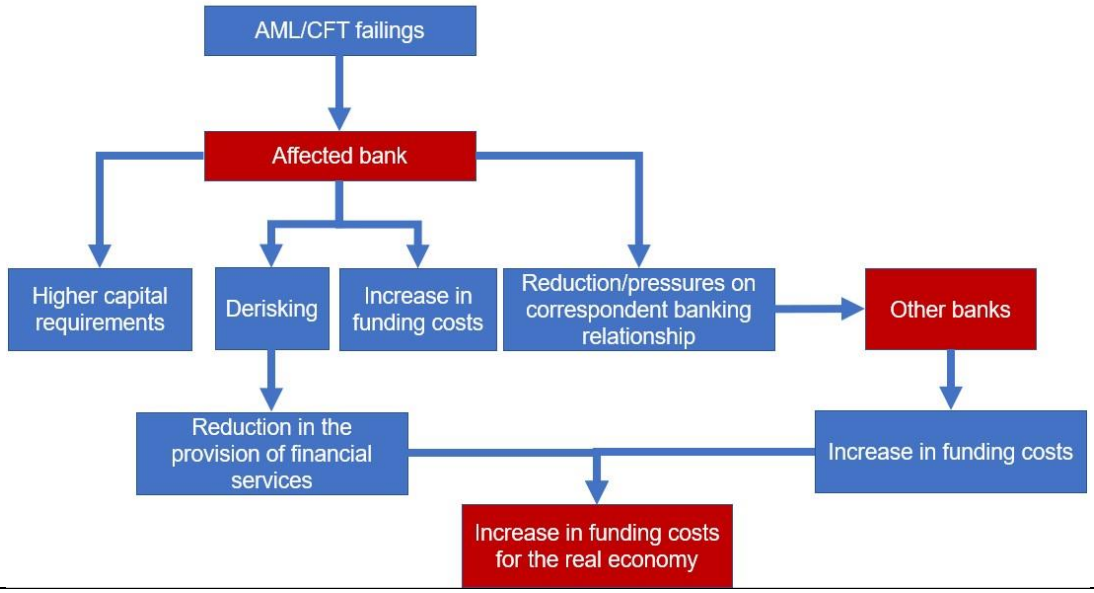


Medium-Term Impact

15. In the medium term, banks facing AML/CFT failures might experience higher funding costs, cost of equity and regulatory requirements that can reduce their profitability. As compliance costs increase, affected banks might also face higher capital requirements, which could weigh on medium-term profitability. As a result, affected banks could reduce their exposures to countries where financial integrity issues occurred. Such cutback on activity could result in a sharp reduction of financial services offered to residents resulting in less competition in the banking sector and higher funding costs for the real economy, especially if the domestic banking sector is reliant on those cross-border banking groups.

16. Medium-term effects could also occur at the sectoral or country level via correspondent banks pressures. ML risk crystallizing in one bank may lead to global banks ending relationships with other local banks, up to the point where it becomes impossible to provide payment and settlement services in certain currencies. A reduction or pressures in CBRs could weigh on the financing activity of the banking sector and ultimately reduce the economic activity of domestic entities (Erbenova et al, 2016). A reduction in CBRs has been observed in some European Union (EU) countries such as Cyprus or Malta (IMF, 2020).

Figure II.2. Medium-Term Transmission Channels



17. Banks impacted by financial integrity issues could also face increased costs to preserve financial stability due to higher resolution and liquidation costs for the affected entities. These issues could result in higher liquidation costs as potential buyers might be reluctant to acquire assets of the troubled entity, with a risk for taxpayers if public funds were to be used. Relatedly, liquidation costs might be higher as financial integrity concerns can affect the value of the assets to be disposed of, leading to lower recovery rates for creditors.

D. Assessing the Impact of AML/CFT Failures on the Banking Sector—The Road Ahead

18. The impact of penalties and misconduct on individual banks' performance has been the main focus of literature so far. Empirical studies find that misconduct and financial penalties have a negative impact on bank performance. From a macroprudential perspective, the European Systemic Risk Board (2015) estimates that misconduct can create uncertainty about banks' business models and their solvency and lead to a reduction in the provision of financial services. Köster and Pelster (2017; 2018) find that misconduct and financial penalties have a negative impact on individual banks (lower profitability and valuation, higher funding costs, and default risk).

19. Empirical studies on the impact on banks' liquidity and funding have been scarce, though, and further work is required to deepen the analysis of the impact on financial stability for banks. A few case studies show that financial integrity issues also lead to an increase in funding costs (Danmarks NationalBank (DNB), 2018) and a deterioration in liquidity for banks with offshore activity (IMF, 2019). Financial integrity issues and their nexus with financial stability have been raised as part of

Fund surveillance activities.[9] However, those risks have not been quantified at regional or country levels.

20. As part of CD activities, staff started to develop an exploratory framework to further calibrate the short-term impact on valuation, credit risk, and liquidity for banks. Data on past financial integrity events could be used to estimate the impact on affected banks and potential contagion effects. The impact can be estimated by comparing changes in financial variables (equity prices, credit default swaps (CDS), spreads, or deposits) around past financial integrity events. Since the observed changes can be due to other factors not related to financial integrity, each financial market variable is to be measured against a benchmark of other banks to control for shocks affecting the banking sector as a whole. This work remains exploratory, and preliminary results laid out in Box II.3 are therefore subject to uncertainty due to the lack of empirical benchmark and the very small sample size of financial integrity events.

The overarching objective of the framework would be to develop financial integrity stress test analysis to better identify vulnerable banks and support risk-based supervision. Using the transmission channels outlined previously as well as the results of calibration exercises, the scenario can be refined and then run-on sample of banks to assess the impact of financial integrity issues on the banking sector and estimate the resilience of individual entities through direct or contagion channels. The banks in scope could be systemic entities as well as banks for which ML/TF risks are identified as high. Overall, this ongoing work would help further integrate financial integrity issues in risk analysis and banks' supervision.

Box II.2. Technical Assistance Case Study

A Pilot Exercise for Calibrating the Impact on Liquidity, measured with Deposit Flows

A regional technical assistance project analyzed selected aspects of the Nordic-Baltic region's AML/CFT regimes.[1] It focused on key ML threats resulting from a novel financial flows analysis (based on cross-border payments data), vulnerabilities related to AML/CFT supervision of the banking sector and VASPs, and the potential impact of financial integrity failures on financial stability.

Assessing the impact of ML on liquidity is key, as financial integrity failures in some regions have triggered very large deposit outflows on some (small) banks in the Nordic-Baltic region. While work on the calibration of the impact of ML events on stock prices and credit risk (measured by CDS' spreads) has been done using commercial data, supervisory information is needed to measure how the liquidity of banks has changed around such events.

Supervisory data includes information on liquidity, funding, and non-resident deposits. Most of the work was focused on the 'maturity ladder' template (labelled C66 in European Banking Authority Common Reporting templates used in the EU), which provides detailed information on a monthly basis about potential outflows by contractual maturity (overnight, one to two days etc.), inflows by contractual maturity and counterbalancing capacity (assets that could be mobilized to cover outflows).

[9] For example, Iceland (2019 and Latvia (2019) AIV consultation staff reports.

Box II.2. Technical Assistance Case Study (Concluded)

The impact of financial integrity events was estimated by comparing deposit levels one month before and after the event. Following an event study approach, data related to the specific month during which a financial integrity event were excluded, and the impact was assessed by comparing deposit information before and after the month when the event occurred. Four financial integrity events occurring in 2018–2019 were chosen.

Supervisory data show that some decline in liquidity—measured by deposits—can be observed around financial integrity events. When a financial integrity event directly affects one bank, the impact on the liquidity is visible. When financial integrity events are related to banks outside of the country participating in the pilot, there could still be some liquidity effects on domestic banks with cross-border exposures to the countries where the ML cases occurred, while other domestic banks did not experience any decline in deposits.

There are several limitations to this study. First, the sample of events is very limited. There is only one event to measure the impact of financial integrity events on the affected bank, which reduces the robustness of the result. This drawback could be addressed if similar analyses were to be performed in countries in the region where banks experienced financial integrity events. While there are more events related to banks outside the country, the sample remains very limited, and some events are overlapping over the estimation window making the identification of the impact of ML events difficult. In addition, changes in liquidity might be driven by other factors than ML events which are not controlled for.

[1] Nordic-Baltic Regional Report: Technical Assistance Report-Nordic-Baltic Technical Assistance Project Financial Flows Analysis, AML/CFT Supervision, and Financial Stability (imf.org)

21. The work could be extended across several perspectives. First, other dimensions of liquidity could be explored, including changes in inflows and counterbalancing capacity around ML events. Second, the analysis could be applied to a wider sample of data to increase the robustness of estimates. Such extension would be particularly useful for countries where there have been ML cases recently and for countries where small to medium-size banks have been directly targeted (as the liquidity effect on smaller banks is likely to be larger). Third, the potential difference between the run-off rates for resident vs. non-resident depositors could be explored to understand if there are different behaviors/reactions that could then be incorporated into a stress scenario on liquidity. Finally, other reporting information could be used to assess other risks around ML events such as changes to other aspects of liquidity (inflows and counterbalancing capacity assess other risks) and of funding and associated costs.

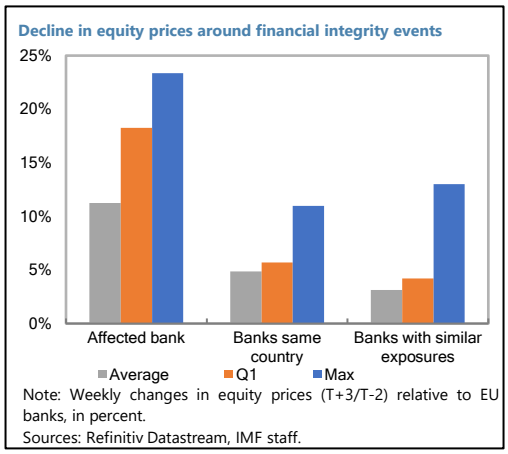
Box II.3. Calibrating the Short-Term Funding and Liquidity Impacts of Financial Integrity Events on Affected Banks, and Other Banks Through Contagion in the Nordic-Baltic Region

AML/CFT failures are associated with a large drop in equity price for the affected bank, and to a lesser extent other banks from the same country and banks from the region with similar cross-border exposures. Box Figure 1 shows that affected banks experience a large decline in stock prices around the event, with an average decline of 11 percent, a third quartile decline of 18 percent and up to 23 percent. Other banks from the same country also experience a decline in price along with banks from the region with similar cross-border exposures. Large regional banks would be associated with the largest contagion effects.

Box II.3. Calibrating the Short-Term Funding and Liquidity Impacts of Financial Integrity Events on Affected Banks, and Other Banks Through Contagion in the Nordic-Baltic Region (Continued)

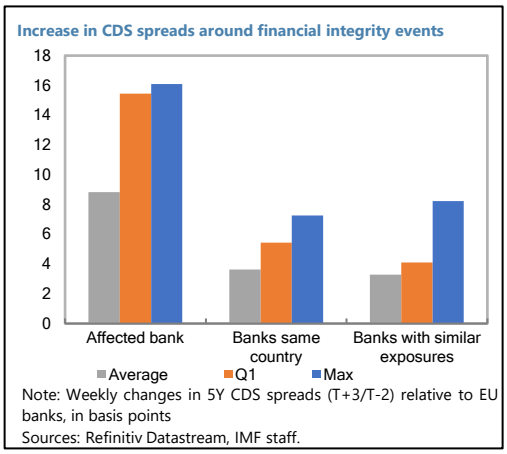
Similarly, credit risk increases around financial integrity events for the affected banks and for other banks in the same country or banks from the region with similar cross-border exposures. Box Figure 2 indicates that credit risk—measured by CDS spreads—increased by around 15 basis points for the affected bank and to a lesser extent for banks in the same country or with similar exposures in the region.

Box Figure 1. Sharp Decline in Stock Prices



Note: Weekly changes in equity prices (T+3/T-2) relative to EU banks, in percent.
Sources: Refinitiv Datastream, IMF staff.

Box Figure 2. Increase in Credit Risk



Note: Weekly changes in 5Y CDS spreads (T+3/T-2) relative to EU banks, in basis points
Sources: Refinitiv Datastream, IMF staff.

Liquidity, as measured by deposit flows, tends to deteriorate around financial integrity events for the affected bank while other domestic banks' liquidity could benefit from positive substitution effects in the short-term. Box Figure 3 shows changes in deposits between the month before and the month after a financial integrity event.[1] Affected banks faced a decline in deposits, with the largest withdrawals from other financial corporations,[2] credit institutions and to a lesser extent to non-financial corporates, in line with assumptions used for liquidity stress testing in FSAP (Box Figure 4). In contrast, other domestic banks non-directly affected tend to see an increase in deposits around the event from same categories of depositors, suggesting that depositors moved out of the affected banks towards other domestic banks.[3] Those results on liquidity have been obtained during a pilot exercise with one country.

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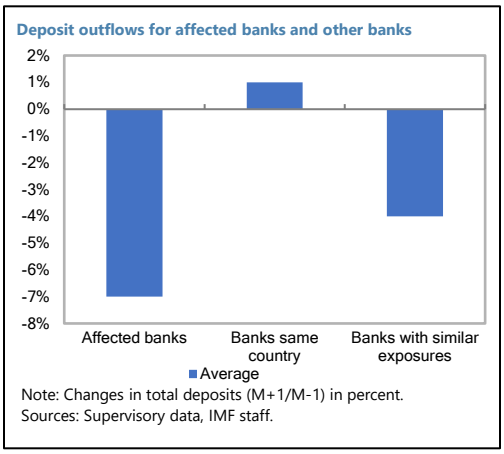
[1] Bank liquidity could also be impacted on the asset side, if financial integrity issues negatively affect the bank counterbalancing capacity though a fall in value (as in IMF, 2019) or, in an extreme case, if foreign banks counterparties stop interacting with the bank in some currencies, making the bank unable to mobilize its holdings of liquid assets in foreign currency to meet deposit withdrawals. In the case of ABLV, a significant amount of its counterbalancing capacity was in U.S. dollar bonds. However, after the publication by FinCEN of the draft measure to ban the bank from having a correspondent account in the United States, ABLV was unable to find counterparties to sell its U.S. dollar bonds to, making it unable to use its counterbalancing capacity to meet deposit outflows.

[2] Other Financial Corporations is defined by the Financial Reporting Standards as "all financial corporations and quasi corporations other than credit institutions such as investment firms, investment funds, insurance companies, pension funds, collective investment undertakings, and clearing houses as well as remaining financial intermediaries and financial auxiliaries" (Annex V, Part 1, Paragraph 6, Article 35).

[3] Substitution effects between banks are difficult to measure as other factors might play a role such as the presence of public banks (which are typically considered safer) or that some banks might be hesitant to accept inflows from clients of banks facing financial integrity issues.

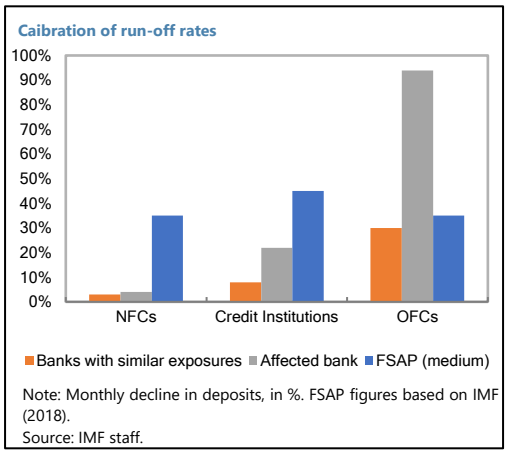
Box II.3. Calibrating the Short-Term Funding and Liquidity Impacts of Financial Integrity Events on Affected Banks, and Other Banks Through Contagion in the Nordic-Baltic Region (Continued)

Box Figure 3. Change in Deposits



Note: Changes in total deposits (M+1/M-1) in percent.
Sources: Supervisory data, IMF staff.

Box Figure 4. Deposit Run-off Rates



Note: Monthly decline in deposits, in %. FSAP figures based on IMF (2018).
Source: IMF staff.

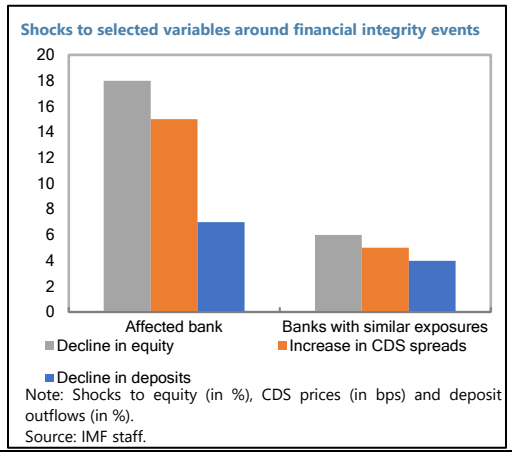
At the regional level, **preliminary results tend to indicate possible contagion effects on the liquidity side**. Financial integrity events affecting cross-border regional banks with headquarters in another country could be associated with deposits outflows for other banks in the region having similar cross-border exposure to the region where the financial integrity event originated, indicating possible contagion effects. Box Figure 3 indicates that banks in the region similar to the one facing a financial integrity event might also experience a decline in deposits.

Overall, actual deposits run-off rates for other financial corporations experienced by banks were higher than assumptions used for liquidity stress testing in FSAPs. While the actual run-off rates were lower than those used in FSAPs for most depositors, outflows for other financial corporations were substantially higher (Box Figure 4), reflecting the volatile nature of those depositors. Such results can imply that banks relying on other financial corporations for a large portion of their funding might be at higher risk of liquidity issues if AML/CFT failures were to occur, as withdrawals tend to be very large around such events.

Box II.3. Calibrating the Short-Term Funding and Liquidity Impacts of Financial Integrity Events on Affected Banks, and Other Banks Through Contagion in the Nordic-Baltic Region (Concluded)

A stress scenario was calibrated based on those results. Box Figure 5 shows a possible calibration of the shock. For the affected bank, its equity price would decline by 18 percent, its CDS spreads increase by 15 basis points, and the bank would face deposit outflows of 7 percent (which corresponds to the estimate in Box Figure 5).[4] Other banks in the country would also face shocks, with a 6 percent stock price decline, an increase in CDS spreads by five basis points and deposit outflows for 4 percent.[5]

Box Figure 5. Shocks in the Stress Scenario



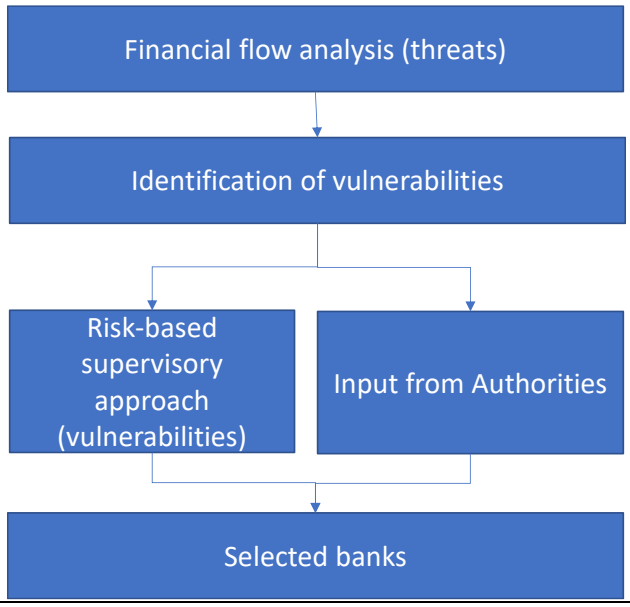
Note: Shocks to equity (in %), CDS prices (in bps) and deposit outflows (in %).
Source: IMF staff.

[4] Based on the pilot, deposit outflows were estimated at 7 percent based on information reported by large cross-border banks. Actual outflows could be higher: ABLV bank experienced deposit outflows of 23 percent in three days in February 2018. The calibration of deposits outflows for banks with similar exposures was obtained by applying outflow rates by types of deposits to the deposit structure of cross-border regional banks in the region in the country.

[5] This calibration is illustrative as the results of the contagion analysis could also be used. In that case, shocks to other banks would likely by higher than in the example above.

22. Close collaboration between prudential supervisors, AML/CFT supervisors, and financial stability experts is key to understanding the impact of financial integrity on financial stability at national and regional levels. Given potential transmission channels between financial integrity and financial stability, stress tests, and risk analyses in the banking sector could include components related to financial integrity issues. An understanding of ML threats and vulnerabilities in the banking sector, derived from AML/CFT supervisors would be key in selecting banks for deployment of the financial integrity stress test scenario. Entity risk-ratings derived from

Figure II.3. Risk Factors: Threats, Vulnerabilities, and Impact



AML/CFT supervisory risk assessments can facilitate such selection of banks with high ML/TF risk exposure. (Figure II.3).

23. As part of the determination of Pillar Two Capital Add-Ons, financial integrity scenarios are sometimes captured under the assessment of a Bank's Operational Risk. These scenarios often relate to serious AML/CFT violations that could generate significant reputational risks. These considerations are often captured on a case-by-case basis and the forward-looking estimation on the impact of an AML/CFT failure on banks is often limited, with the "operational risk event" typically calibrated based on past events overshadowed by these risks given the inadequacy of the weight assigned to ML/TF risks.

24. By deepening the analysis of the impact of financial integrity on financial stability, banks will be positioned to determine whether additional capital buffers are required. Through better analysis and incorporation of these shocks, this, in turn, will allow banks to ensure that required levels of capital are maintained in order to withstand any associated shocks that could potentially impact their stability.

25. Countries require guidance on how to better analyze and mitigate the impact of financial integrity failures on financial stability. Through staff's development of a framework for the assessment of the impact of financial integrity (including through the incorporation of these considerations into AML/CFT supervision and prudential supervision), countries will be better positioned to safeguard the stability of the financial system. This analysis and policy advice can then be incorporated, in a more detailed manner, across several Fund workstreams.

E. Coverage of AML/CFT in the Fund's Core Functions

26. Going forward, engagement with countries as part of the FSAP process would provide opportunities to take forward and deepen this analysis. In 2010, the Fund Executive Board made financial sector stability assessments under the FSAP a mandatory part of surveillance under AIV for jurisdictions with systemically important financial sectors.[20] FSAPs offer a more in-depth focus on financial sector issues which is a complement to the higher frequency macro-financial surveillance in AIV consultations. This analysis can be brought into FSAPs by expanding the scope of stress testing related to AML/CFT failures. This inclusion could be determined on a case-by-case basis, where there is a country with key financial integrity risks (e.g., high threats from ML/TF, weak AML/CFT supervision and preventive measures). The focus of the analysis could be further determined based on the specific threats the country faces (including use of financial integrity scenarios in other countries/regions, calibrated to the specific circumstances of the country being assessed). Integrating this deepened analysis into FSAPs would also lessen the burden on country authorities, as we confirmed through the pilot exercise that the data used is typically collected as part of an FSAP. Further, FSAPs can inform the analysis of financial sector issues in AIV consultations, especially in the case of mandatory FSAPs.

27. AIV engagements also could cover banking stability impacts from systemic deficiencies in AML/CFT supervisory frameworks when macro-critical.[10] Staff can leverage the increased availability of FSAPs coupled with ML/TF risk-relevant information, both from member countries (greater availability of updated national and sectoral risk-assessments) as well as quantitative information (e.g., cross-border payments data) to improve understanding of risks facing the banking sector. This will allow further focus on AML/CFT supervision in the banking sector in cases where the sector is exposed to high risks, and where AML/CFT failures could have potential financial stability impacts.

28. The analysis will also be broadened to assess the impact on other sectors. While banks continue to play a central role in the financial system, new entrants (e.g., VASPs) and other non-bank sectors are also vulnerable to ML/TF risks and further analysis is required to better understand the impact of AML/CFT failures on these sectors. In addition, the analysis will be expanded to further consider cross-border impacts and group structures (including groups that combine banking and other financial sector activities/entities).

29. In line with the demand for the analysis of financial stability impacts of financial integrity failures in advanced economies, it is anticipated that this trend will continue. In a recent regional CD project, the Fund piloted a novel methodology to explore financial stability impacts of financial integrity events jointly with the analysis of cross-border ML/TF risks as well as vulnerabilities in risk-based AML/CFT supervision. This project allowed the development of a methodology to analyze financial stability impacts of AML/CFT failings. Since then, training modules on assessing financial stability impacts have been developed and delivered in regional trainings.

30. This analysis would also be highly relevant to LIC and emerging economies where the banking sector is prone to high financial integrity risks coupled with liquidity constraints. Liquidity pressures stemming from financial integrity failures may be higher for small and medium size banks. Lower income jurisdictions may also be more likely to experience correspondent banking relationships pressures affecting the banking sector due to assessed or perceived compliance weaknesses. Quantifying such impacts in these countries could help inform prudential and AML/CFT supervision efforts to mitigate systemic impacts from AML/CFT failures.

[10] Financial integrity issues are covered in AIV consultations when they are macro-critical, i.e., when these issues significantly influence present or prospective balance of payments and domestic stability or when spillovers from these policies may significantly influence the effective operation of the IMS, see the 2012 ISD.

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BACKGROUND PAPER III: RELEVANCE OF AML/CFT TO OTHER FUND POLICIES

Executive Summary

This background paper highlights the relevance of AML/CFT and broader financial integrity issues in the context of other Fund policies. It discusses the nexus between AML/CFT and a range of Fund policies, including the Framework for Enhanced Engagement on Governance (2018, and 2023 review), the Board Paper on Recent Trends in Correspondent Banking Relationships (2017), the Fund Policy Paper on Elements of Effective Policies for Crypto Assets (2023), the Review of the Role of Trade in the Work of the Fund (2023), the Strategy for Fragile and Conflict-Affected States (2023), the Board Paper on Small States' Resilience to Natural Disasters and Climate Change (2016), the Review of the Institutional View on the Liberalization and Management of Capital Flows (2022), the Strategy to Help Members Address Climate Change Related Policy Challenges, Modes and Delivery and Budget Implications (2021), the Central Bank Transparency Code (2021), and the Review of Flexible Credit Line, Short-Term Liquidity Line, Precautionary Liquidity Line (2023).

A. Background[1]

1. AML/CFT issues are integrated in a range of Fund policies. Financial integrity issues are highly relevant to the broader policy agenda of the Fund: For instance, AML/CFT tools are vital in anti-corruption efforts, appropriate AML/CFT measures are necessary to mitigate ML/TF risks associated with VAs and other forms of digital money, and financial integrity safeguards are key to climate change policies and programs (for instance, to prevent the misuse of carbon emission credit exchanges to defraud taxpayers and limiting the laundering of proceeds of environmental crimes). Further, TF concerns could be acute for FCS, and assessing and mitigating TF risks is a key element in country engagement with FCS members in the Fund's FCS strategy. Accordingly, AML/CFT and broader financial integrity issues have been integrated in a range of Fund policy papers where these considerations are relevant. The relevant workstreams under the AML/CFT strategy are constantly aligned with the Fund's relevant policies on surveillance, lending, and CD (e.g., the Comprehensive Surveillance Review, Review of Program Design and Conditionality, and the CD strategy).

B. Framework for Enhanced Engagement on Governance

2. Some AML/CFT tools are of high relevance for the governance policy. AML/CFT is one of the six state functions under the governance framework, with a focus on the use of four specific AML measures (out of the 40 Recommendations) that are also useful to tackle proceeds of corruption at

[1] Prepared by Arz Murr, Jonathan Pampolina, Francisca Fernando, Ke Chen, Santiago Texidor Mora, Mohammed Janahi, André Kahn, and Indulekha Thomas (all LEG).

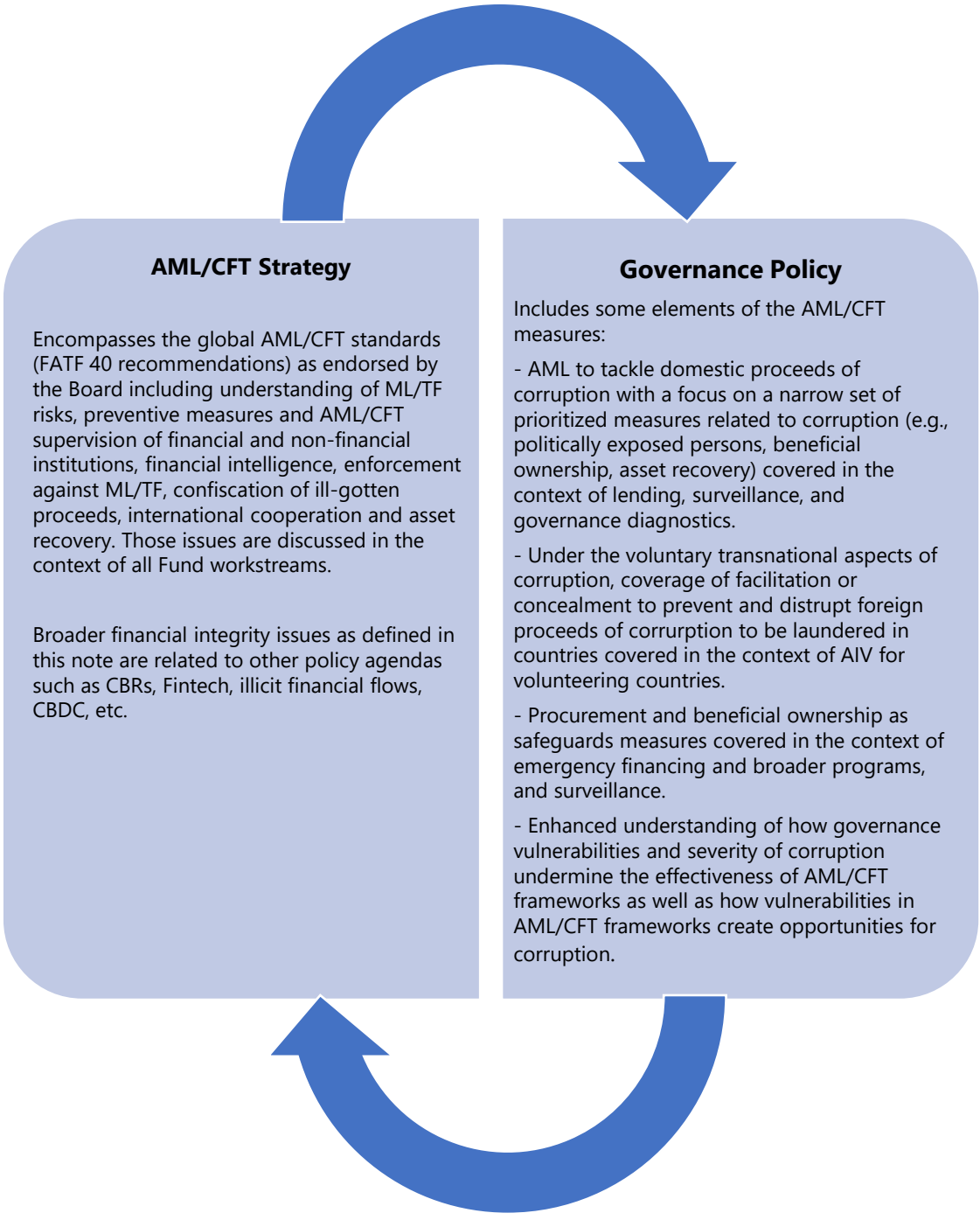
the domestic level.[2] These specific measures relate to preventive measures, enforcement against ML and international cooperation and asset recovery requirements. The 2023 Review of the Implementation of the 2018 Governance Policy covered staff's engagement on AML/CFT issues as one of the six state functions, noting that staff identified vulnerabilities stemming from weak AML/CFT frameworks in 25–35 percent of the membership since the 2018 Framework was put in place. Discussions on AML to tackle domestic proceeds of corruption have been included in surveillance, lending, governance diagnostics, and CD. In a notable example of the use of AML/CFT tools to tackle corruption, commitments on beneficial ownership transparency were included in COVID-19 related emergency financing to improve transparency and accountability in public procurement (Box III.1).

3. Another element is the voluntary assessment of transnational aspects of corruption with a focus on "facilitation" through the assessment of the effectiveness of the AML framework in combatting the foreign proceeds of corruption in the members' economies. Such coverage in surveillance is assessed on a voluntary basis under the transnational aspects of corruption, and covers elements of the AML/CFT standards, such as preventive measures (e.g., foreign politically exposed persons), enforcement against ML generated by foreign proceeds of corruption, and international cooperation and asset recovery requirements, that are equally beneficial in the fight against ML and corruption (and its proceeds). The 2023 Review of the governance policy also assessed the voluntary coverage of transnational corruption in Fund surveillance, noting that the voluntary coverage since 2018 has identified the need to strengthen the frameworks related to identification of cross-border risks, transparency of beneficial ownership information, and preventive measures as well as asset recovery efforts.

4. Corruption and governance vulnerabilities could also undermine the effectiveness of the AML/CFT framework, and staff will continue looking at those structural aspects. Governance vulnerabilities and the severity of corruption affect the effectiveness and outcomes of AML/CFT systems. For instance, AML/CFT frameworks are weakened if the governance of the AML/CFT supervisors or financial intelligence units (FIUs) is undermined, or if judiciary or law enforcement agencies are corrupt. Staff will continue deepening the assessment of those structural issues under various workstreams and provide relevant policy advice and recommendations, as appropriate.

[2] The six state functions are (i) fiscal governance; (ii) financial sector oversight; (iii) central bank governance and operations; (iv) market regulation; (v) rule of law; and (vi) AML/CFT.

Figure III.1. Nexus Between the Governance Policy and AML/CFT Strategy and AML as a State Function Under the Governance Policy



Box III.1. Entity Transparency and COVID-19-Related Procurement

The global pandemic gave rise to significant issues of transparency of emergency procurement. Country authorities needed to act rapidly in procuring necessary equipment and medicines as part of their pandemic responses. Lockdowns and travel restrictions exacerbated global supply chains, which further added pressures to act fast in the context of emergency-related procurement. Funds dedicated to the pandemic response needed to be fully maximized and devoted to their intended purposes. Misuse of these funds would have weakened the effectiveness of the COVID-19 response, hampered post-pandemic economic recovery, and disproportionally impacted vulnerable sectors and people.

Leveraging existing AML/CFT and governance tools (i.e., beneficial ownership in procurement) contributed to transparency in public procurement in response to the COVID-19 pandemic. When opening accounts with financial institutions, companies are generally required to disclose their beneficial ownership information. A beneficial owner is the natural person who ultimately owns, or controls, a legal person. Replicating this concept, these companies can submit that same beneficial ownership information also to procurement authorities when bidding for contracts. Conditionality in several Fund-supported programs advanced these reforms. Such reforms included the following elements: (i) requiring submission of beneficial ownership information; (ii) prima facie verification by the procurement authority; (iii) public access to the beneficial ownership information of the awarded company; and (iv) enforcement mechanisms for non-compliance or untrue submissions. The reforms helped identify the beneficial owners of companies awarded contracts, prevent conflict of interest, and brought greater transparency in public procurement. While such sectorial reform is important in the absence of national initiatives, countries with public beneficial ownership registries have an even easier task in this regard, with no additional implementation costs as long as the name of the awarded company would be known to the public, as the information on beneficial ownership would already be available.

C. CBRs

5. The 2017 Board Paper on recent trends in CBRs examines the drivers of the withdrawal of CBRs, and *inter alia* identifies weak AML/CFT frameworks as a contributory factor for such withdrawals. The paper also notes that factors behind CBR withdrawals are multiple and interrelated, and involve risk assessment considerations. It also identifies the need to improve AML/CFT frameworks as well as respondent banks' application of AML/CFT preventive controls among strategies to address the withdrawal trends.

6. Staff continues to implement a multipronged approach to support its member countries to ease pressures on CBRs. Elements of this approach include: (i) monitoring trends, risks and drivers and developing policy advice in its surveillance, (ii) facilitating dialogue among stakeholders, (iii) developing policy responses in its surveillance work; (iv), tailoring CD to help affected countries strengthen their legal, regulatory, and supervisory frameworks.

7. The Fund has also been supporting the G20 Roadmap for enhancing cross-border payments. In particular, the Fund, jointly with the World Bank, has been leading Building Block 7 on safe payment corridors. The safe payment corridors framework aims to reduce the cost of remittances, de-risking, and correspondent banking pressures in lower ML/TF risk remittance corridors by decreasing the compliance and regulatory costs for remittance service providers and their banks. The framework for the remittance corridors risk assessment to identify safe payment corridors has been

published on the Fund and Financial Stability Board websites. The Fund has initiated several outreach efforts to raise awareness about the benefits of implementing the safe payment corridors methodology and offers support to member countries willing to volunteer to its pilot implementation.

8. Going forward, staff will continue to analyze CBRs issues, and discuss possible solutions to reduce pressures that countries face. Notably, the diversification of international payments, including through new and evolving forms of digital money and payment systems, will have an impact on the multipronged approach and tools available to ease CBR pressures. Staff will also expand the scope of possible drivers on CBR pressures, such as the lack of international cooperation and exchange of information caused by excessive financial secrecy and data protection frameworks. Staff will continue exploring possible solutions, such as—in cases where domestic banks lose their correspondent banking relationships—the provision of financial sector services by regional financial institutions that are effectively regulated and supervised by their home jurisdiction, backed by strong bilateral cooperation between the home and host authorities.

D. Digital Money

9. The 2023 Fund Policy Paper on Elements for Effective Policies on Crypto Assets calls for countries to implement the FATF standards (which include recommendations related to VAs and VASP) to address risks to financial integrity. The Board Paper also identifies the need for countries to monitor and mitigate ML/TF risks related to decentralized finance projects and peer-to-peer transactions, which may require creative risk mitigation techniques.

10. Furthermore, the 2021 Board Paper on the Rise of Public and Private Digital Money: A Strategy to Continue Delivering on the IMF's Mandate also recognizes the need for CBDCs and privately issued digital money to be regulated to ensure financial stability and financial integrity (see Box III.2). With the support of external donors, and in response to the increasingly high demand for assistance on AML/CFT issues in relation to Fintech/digital money, staff provided significant CD on two different fronts.

11. A CD project aimed at supporting members in implementing the FATF standards for VAs and VASPs has been rolled out at both regional and country levels. A four-day training program was notably delivered to hundreds of participants from jurisdictions in the Asia and Pacific, Middle East and North Africa (MENA), Sub-Saharan Africa, and Caribbean regions. Assistance with legal drafting, training and policy advice was also provided to countries on a bilateral basis (e.g., Albania and Georgia.). Given the demand for support in AML/CFT monitoring of VASP, tools for risk-based supervision of VASPs are currently under development.

12. Another CD project focuses specifically on CBDC. Staff is conducting in-depth analysis of the financial integrity implications associated with various CBDC design options (e.g., token vs. account-based, retail vs. wholesale, domestic vs. cross-border) and mode of implementation/distribution (direct or indirect dissemination). On that basis, it has also been assisting various members who are currently exploring CBDC (e.g., Jordan, Haiti, and Peru), and focused the

discussions on raising awareness of the potential ML/TF risks and implications on a jurisdiction's AML/CFT regime raised by design choices.

13. While some digital products, such as VAs, may raise ML/TF risks, others may greatly help the effectiveness of AML/CFT measures (Box III.2). The FATF has published a detailed report about the opportunities and challenges associated with the use of technology in AML/CFT. In a context broader than AML/CFT, the Fund and other international financial bodies are also analyzing the implications of the use of technology in finance by the authorities and regulated entities.

Box III.2. Digitalization and the Use of Technology in Fighting ML/TF

Four examples of the use of technology in AML/CFT are discussed briefly below: New forms of digital identity (ID), regulatory technology (RegTech), supervisory technology (SupTech) and distributed ledger technology (DLT).

- **Digital ID** has been widely adopted and supported in many jurisdictions as an alternative to traditional, paper-based forms of ID. The FATF has issued guidance to assist country authorities, reporting entities and other stakeholders in determining how digital ID systems can be used to conduct certain elements of the CDD required under its standard. A digital ID system must rely on technology, adequate governance, processes, and procedures that provide appropriate levels of confidence that the system produces accurate results. If properly used, a reliable, independent digital ID system can support identity verification, client screening, and transaction monitoring, thereby help develop a more accurate understanding of the business relationship. Digital ID may also improve customer access to financial services through mobile devices and smart phones whilst ensuring the security and accuracy of customer information through biometric information as a supplement to personal identity information. The COVID-19 crisis may have further promoted the use of digital ID as the demand for remote financial services delivery increased.
- **Regtech** solutions are increasingly used by regulated entities (including DNFBPs) in some instances) to facilitate compliance with their AML/CFT obligations. Technology-enabled analytic tools and AI models, in particular, can be powerful in gathering and analyzing large amount of data for a range of tasks including identity management and transaction monitoring. In addition to efficiency gains, these tools can also help improve the accuracy of information and reduce false positive alerts, thus leading to greater effectiveness in AML/CFT controls, such as customer risk assessment and transaction monitoring.
- The growing number of supervised entities (such as VASPs and other Fintech/digital money firms) as a consequence of digitalization has contributed to the increasing need for and use of **Suptech** by supervisors. Similar to RegTech, Suptech are technology-enabled tools that can assist with AML/CFT tasks of supervisors and other competent authorities (such as the FIU). Suptech tools can help facilitate secure, automated data collection from supervised entities, run validation tests to verify the quality, content and structure of reports, and funnel processed data into the data lake creating a consolidated, single and access-controlled data architecture. Some solutions can also automate some aspects of the ML/TF risk assessment process to inform the development of a supervisory strategy. Machine learning and AI-driven analytics can also support FIU's analyses of suspicious transactions and identification of trends and patterns.

Box III.2. Digitalization and the Use of Technology in Fighting ML/TF (Concluded)

- **DLT** offers new opportunities particularly in improving traceability of transactions including on a cross border basis and global scale. This could potentially increase the monitoring possibilities by public and private sectors compared to the existing frameworks. A responsible and regulated use of DLT for data and process management purposes may also speed up the CDD process, as customers can authenticate themselves and can even be automatically approved or denied through smart contracts that verify the data. There are however important limitations to blockchain analytics, including geo-blockers (such as the virtual private network), off-chain transactions, and privacy enhancing mechanisms (such as mixers and multiple layers of encryption, stealth addresses, and ring signatures).[1]

An appropriate use of digital tools requires certain prerequisites: In particular, legal and regulatory clarity is crucial to enable an innovation-friendly environment while overcoming some of the associated challenges. While the responsibility for compliance with AML/CFT requirements remains with the regulated entities, the authorities have a role to play to enable innovation and allow the market to support trustworthy and proven technologies to achieve an effective AML/CFT framework. To this end, the authorities should ensure clarity in the legal framework governing the use of technology by regulated entities and the authorities while maintaining technological neutrality. The regulatory and supervisory approach to the use of technology by regulated entities should be in line with the risk-based approach, consistent, outcome-based, technological neutral, and clearly communicated (for instance by issuing guidance) to the market players. Regulatory sandbox or pilot programs are useful tools for both the authorities and regulated entities to identify the risks and the benefits of the technology and inform the design of the regulatory approach.

Staff will continue to follow the trends of leveraging the use of technology in AML/CFT and support members as appropriate to achieve greater effectiveness and efficiency including by advising on legal and regulatory frameworks.

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[1] See: IMF, Elements of Effective Policies for Crypto Assets (2023).

E. Climate Change

14. The AML/CFT issues were highlighted under the 2021 Fund Strategy to Help Members Address Climate Change Related Policy Challenges: Priorities, Modes of Delivery and Budget Implications. The paper recognizes the Fund's collaboration on climate work with a range of stakeholders including multilateral institutions, standard-setting bodies, and civil society, noting, *inter alia*, staff's contributions to FATF's work on climate and environmental crimes.

15. Going forward, the Fund's AML/CFT strategy will continue to contribute to global efforts to combat environmental crimes by mitigating its financial incentives. Staff will aim to increase understanding of risks of environmental crimes, build relevant authorities' capacities to assess and mitigate associated ML/TF risks, and contribute to the global policy agenda on climate change and financial integrity. In this regard, staff will leverage key financial integrity and AML/CFT-related tools, including strengthening assessment of risks, effective implementation of AML/CFT preventive measures (e.g., CDD, identification of beneficial owners), enhancing risk-based supervisory approaches, strengthening financial investigation capacities, and facilitating international cooperation.

Box III.3. Climate Change, Environmental Crimes, and Financial Integrity

Environmental crimes negatively affect climate and can have significant macroeconomic impact. Environmental crimes (such as forestry crimes, illegal mining, illegal fishing, and illegal wildlife trade) can result in large-scale pollution, deforestation, degradation and overexploitation of species and generate significant illicit proceeds. These can in turn threaten vital ecosystem services, destroy natural carbon sinks, and worsen climate change impacts. Economic development and growth are also hindered as environmental crimes can dispossess governments of significant fiscal revenues and deprive citizens of sustainable livelihoods. The World Bank estimated that US$7–12 billion in fiscal revenues are lost each year by resource-rich countries to illegal logging, fishing and wildlife trade (Illegal Logging, Fishing, and Wildlife Trade: The Costs and How to Combat It, 2019). Proceeds from environmental crimes often finance armed criminal or terrorist groups, which can lead to instability and insecurity as well.

Environmental crimes generate significant illegal proceeds, which continue to grow, and are linked to other proceeds-generating crimes. Environmental crimes are highly profitable to criminals, generating around US$110–281 billion annually, according to INTERPOL estimates (World Atlas of Illicit Flows, 2018). These illegal activities generate significant cross-border financial flows, which are challenging to detect especially when commingled with licit trade (e.g., timber, fish, or mineral products) or leveraging TBML activities. What makes environmental crimes even worse is the associated proceeds-generating offenses such as bribing of public officials, labor exploitation, or human trafficking, and smuggling of drugs or cash. Estimated annual growth rate of environmental crimes range from a low of 5 to 7 percent to as high as 21–28 percent. (UNEP-INTERPOL, The Rise of Environmental Crimes, 2018).

Calls for stepping up efforts to address ML risks related to environmental crimes have been intensifying. The FATF (the international AML/CFT standard setter) is stepping up its work in this area, noting that tackling ML linked to environmental crimes is often an overlooked part of a much larger solution to helping save the climate.[1] Similarly, the G7 underscored the need for countries to fully implement the FATF Standards as "environmental crimes have a serious impact on the planet's biodiversity, generate billions of dollars in illicit finance and enable corruption and transnational organized crime."[2] The G20 meanwhile called for intensified efforts to end illicit threats to nature and crimes that affect the environment, including by greater cooperation to combat IFF deriving from crimes that affect the environment.[3]

[1] FATF, High-Level Conference on Environmental Crime (December 7, 2021).

[2] G7, Finance Ministers & Central Bank Governors Communiqué (London, June 5, 2021).

[3] G20, Environnent Communiqué (Naples, July 22, 2021).

F. Central Bank Transparency

16. The Central Bank Transparency Code 2021, a voluntary code to help central banks review their transparency frameworks, sets out principles on transparency on central bank policies, operations, and outcomes related to its internal AML/CFT controls as well as its external AML/CFT supervisory mandate (for central banks that have this mandate). The findings of the pilot reviews for eight countries highlighted that due to the novelty of the requirement to make disclosures on financial integrity, there is significant scope for enhancing transparency in this area. Central banks with AML/CFT supervisory mandates have only limited disclosures on the scope of their activities, such as general information on AML/CFT supervisory policies, powers, and processes. Additional disclosures would strengthen trust in this central bank function, including how: (i) they assess the ML/TF risks of the supervised institutions; (ii) they define their supervisory policies; and

(iii) they allocate internal resources to these activities. Moreover, disclosures of supervisory activities convey the supervisory expectations and has an impact on the degree of AML/CFT compliance by supervised entities. Central banks also need to enhance the transparency on their internal compliance framework related to the activities and services that may give rise to ML/FT risks. When applicable, they should publish information on their internal AML/CFT framework and policies (including resource allocation) and oversight of their effectiveness. In some cases, it would be a simple step such as updating existing webpages, as the information already exists internally.

G. Trade

17. The 2023 Review of the Role of Trade in the Work of the Fund specifically identifies the role of customs agencies in the fight against the trafficking of illegal goods connected to ML/TF. The policy paper also explores the rising costs for trade payments from shrinking correspondent banking networks, particularly in countries with AML/CFT compliance concerns, as well as the role of digital currency in alleviating the impact of these pressures.

H. FCS

18. The Fund's Strategy for Fragile and Conflict-Affected States (2022) notes that country engagement strategies (CES) for FCS will cover six pillars including possible constraints to reform implementation stemming from governance vulnerabilities and ML and TF risks. The paper also identifies AML/CFT and broader financial integrity issues (with focus on topics such as legal and institutional frameworks, enforcement against key proceeds of crime, TF) as a critical area for CD for FCS. While still nascent, AML/CFT issues have been discussed in some CES developed since the adoption of the FCS strategy in 2022. For instance, the CES for Somalia notes the need for implementation of AML/CFT-related action plan to strengthen CBRs. The CES for Congo, which notes CD as a central part of the Fund's engagement with the country, identifies anti-corruption and AML/CFT as key CD areas. Further, the CES for Mozambique notes reform efforts in AML/CFT, among others.

19. In general, the Fund covers AML/CFT issues, where relevant, in surveillance and lending for FCS and provides tailored CD support on AML/CFT. Dependent on the vulnerabilities of the FCS members, common themes covered include measures to combat TF, reforms to mitigate laundering of proceeds of corruption (often covered as part of broader anti-corruption reforms) and organized crime, as well as the strengthening of AML/CFT frameworks to reduce CBR pressures. The Fund's work on CFT (outlined in Box III.4) is of particular relevance for FCS, where terrorism financing could have significant macroeconomic impacts (e.g., if terrorist groups may seize control of natural resources). For instance, CFT is discussed in the Mali 2023 AIV, which notes the vulnerabilities of the mining sector to corruption and TF and urges greater transparency and AML/CFT risk-based supervision of the sector. The ECF for Somalia includes a structural benchmark on implementing targeted financial sanctions reform, in recognition of the critical need for sustained progress on AML/CFT issues. Further, reforms to combat illicit outflows from corruption are discussed in Lebanon and Ukraine (the program includes a structural benchmark related to mitigating ML risks from

politically exposed persons). Engagement with Papua New Guinea (2022), Tuvalu (AIVs 2023 and 2021), and Zimbabwe included a discussion on strengthening AML/CFT frameworks to address CBR pressures. In addition, the Fund had bilateral CD engagements with Haiti, Sudan, South Sudan, and Timor-Leste on the establishment of AML/CFT legal frameworks, while Haiti, Solomon Islands, Ukraine, West Bank and Gaza, and Zimbabwe participated in multi-country and thematic AML/CFT projects.

Box III.4. The Fund's Work on CFT

What started as a relatively modest effort is now a comprehensive, multipronged work program that benefits the entire membership in response to emerging events and global initiatives. The Fund's work initially covered AML only. Following the events of September 11, 2001, the Fund's work was extended to cover CFT issues. At the first No Money for Terror conference in 2018, former Managing Director Christine Lagarde said that the Achilles's heel of terrorism is its financing. CFT issues have been addressed in broader policy discussions, including those on governance, correspondent banking, Fintech/digital money, and Islamic finance.

Staff brought its unique expertise to global CFT efforts in several areas of engagement:

- Staff covered CFT in the context of bilateral surveillance (e.g., Iran and Iraq AIVs; Turkey FSAP) and Fund-supported programs (e.g., Pakistan, Iraq).
- Staff also provided CD to improve its members' CFT frameworks (Iraq, Tunisia, etc.). Some of the projects were exclusively focused on CFT issues. A CD project funded by Canada assisted six MENA countries in strengthening their CFT legal frameworks between 2016–2020.
- Staff also conducted research on TF matters and published in Q2 2023 a book on Suppressing Terrorism Financing: Good Practices to Enhance Effectiveness.[1] This book was researched and edited by staff with contributions from several recognized experts from other institutions, including the UN, Egmont Group of FIUs, Interpol, and Europol. It provides guidance to practitioners to better identify key challenges and good practices in strengthening their CFT frameworks.
- Staff also assessed countries against the FATF Standards, in particular Côte d'Ivoire, a country where CFT efforts are of utmost importance as it faces increasing terrorist and TF risks from groups operating in the nearby Sahel region.
- In May 2023, the Fund joined, as an observer, the UN Global Counter-Terrorism Coordination Compact. The Compact is an inter-agency platform for coordination on counterterrorism, including CFT matters. Coordination under the Compact will enable staff to better coordinate CD efforts with other providers.

Going forward, staff intends to build on the Fund's strategy for FCS as fragility and/or conflict can further hinder the fight against TF. Those risks have potential spillover effects that materialize as TF/sanctions evasion risks. For instance, countries neighboring FCS or having financial connections with FCS facing high terrorism/TF risks might in turn experience higher TF risks. TF-related data can help gain a more in-depth understanding of such spillover effects and tailor our engagement with member countries experiencing such effects. The understanding of TF risks can also be leveraged to assess constraints to reform implementation and therefore improve staff's engagement with member countries, including FCS, in the context of Fund surveillance, lending, and CD.

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[1] El Khoury, Chady, editor, "Suppressing terrorism financing, good practices to enhance effectiveness", IMF 2023, Washington DC.

I. Small Developing States

20. The 2016 Board Paper on Small States' Resilience to Natural Disasters and Climate Change—Role of the Fund includes a reference to the ML/TF vulnerabilities of small states, particularly distinguishing small states that operate OFCs.[3] These issues are further highlighted in the Staff Guidance Note on the Fund's Engagement with Small Developing States (2017). The Guidance Note highlights financial stability and inclusion risks from the disruption of correspondent banking services and notes that the Fund should continue to support member countries in addressing issues from the withdrawal of CBRs, including through strengthening AML/CFT frameworks. Reputational risks from weaknesses in AML/CFT and tax frameworks are also noted as particularly high for small states engaging in higher-risk activities (offshore financial sectors and citizenship by investment programs). The Independent Evaluation Office's (IEO) 2022 Report on the Fund's engagement with small developing states (SDS) also highlights risks faced by SDS that operate offshore financial sectors. In general, the IEO Report notes good coverage of AML/CFT issues in engagement with SDS between 2010 and 2020, highlighting ample attention to AML/CFT issues and CBR pressures in AIVs and legislative reform on AML/CFT issues in Fund-supported programs.

J. Capital Flows

21. The 2022 Review of the Institutional View on the Liberalization and Management of Capital Flows recognizes the need for an effective AML/CFT framework implemented commensurately with ML/TF risks and in accordance with international standards. The paper thus sets out that the measures implemented in accordance with the FATF Standards, which may affect cross-border capital movement (including countermeasures and enhanced due diligence for business relationships and transactions from higher-risk countries) will not be assessed for appropriateness under the criteria established in the Institutional View.

K. 2023 Review of the Flexible Credit Line, the Short-Term Liquidity Line and the Precautionary and Liquidity Line, and Proposals for Reform

22. The 2023 Review of FCL, SLL, and PLL formally integrates AML/CFT considerations into the qualifications framework for the precautionary toolkit under the 'effective financial sector supervision' criterion**.** A FATF-listed country would be unlikely to qualify for an FCL or SLL if staff assesses that the deficiencies resulting in the listing indicate that the criterion for "effective financial sector supervision" is not met. For PLL arrangements for listed countries, countries will be expected to commit to addressing strategic AML/CFT deficiencies relevant to the financial sector supervision, supported by conditionality if critical to achieving program objectives.

[3] The Board Paper notes the need to develop a robust AML/CFT framework for small states given the pressures faced on CBRs as well as the offshore nature of financial sectors in some small states.

BACKGROUND PAPER IV: THE FUND'S RELATION WITH THE FATF GLOBAL NETWORK AND EGMONT GROUP OF FIUS

Executive Summary

This background paper explores the Fund's relationships with the FATF Global Network and the Egmont Group of FIUs (Egmont Group). In relation to the FATF, the paper discusses the FATF Standards and their evolution, the Fund's contribution to assessments, the framework to ensure the quality and consistency of AML/CFT assessments, and the FATF's high-risk and other monitoring jurisdictions or International Co-operation Review Group (ICRG). In relation to the Egmont Group, the paper highlights the Fund's relationship with Egmont Group, the importance of FIUs as key AML/CFT institutions, the challenges they face, and how the Fund—in coordination with Egmont Group—could strengthen their role and functions further.

A. Background[1]

1. The Fund's AML/CFT strategy and broader financial integrity issues is implemented in coordination with the FATF and other multilateral institutions. The Fund's strategy focuses on financial integrity issues with significant macroeconomic impacts. On the other hand, the FATF works to protect the financial system against ML/TF through standard setting, assessments of all FATF and FSRB members' AML/CFT frameworks, and typologies work. The Egmont Group aims to foster cooperation and information exchange between FIUs. Staff closely cooperates with the FATF and other international organizations through participation in and contributions to standard setting, typologies, and assessments of member countries' AML/CFT frameworks and coordination of CD delivery.

B. The Fund's Relation in the FATF Global Network

2. The FATF is the global AML/CFT standard-setting and monitoring body whose purpose is the development and promotion of national and international policies to combat ML, TF, and, more recently, PF. The FATF was established by the G7 in 1989 and is hosted by the OECD in Paris. As a policy-making body, the FATF works to generate the necessary political will to bring about national legislative and regulatory reforms in relation to AML/CFT. The 39-member body sets international standards to ensure national authorities can effectively go after money laundering linked to crimes, such as from drug trafficking, the illicit arms trade, cyber fraud, environmental crimes, tax crimes, and other serious crimes, and TF, and prevent them from entering the financial system. In total, more than 200 countries and jurisdictions have committed to implement the FATF standards as part of a coordinated global response to preventing ML/TF. Countries that are not a member of the FATF are a member of one or more of the nine FSRBs. These FSRBs have the status of Associate Members at the

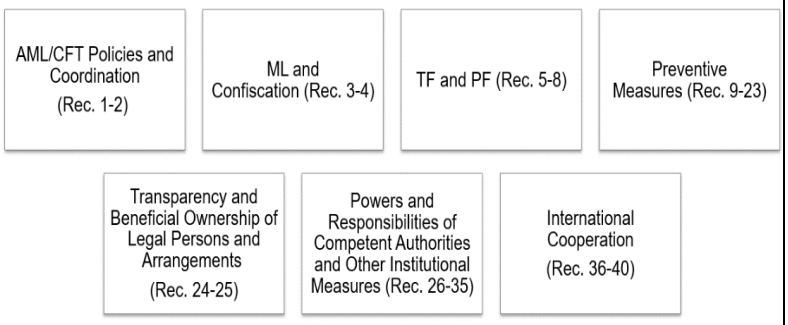
[1] Prepared by Robin Sykes, Carlos Acosta, Peter El Sharoni, and Miho Tanaka (all LEG).

FATF, and FSRB members have access to FATF meetings and documents and can contribute to the FATF's work (e.g., inputs in the design and update of the standards). The Fund and World Bank are observers to the FATF and the nine FSRBs.

The FATF Standards and Their Evolution

3. The FATF sets out 40 Recommendations on measures that countries should implement to combat ML, TF, and PF. The standards serve as the basis for a coordinated response across jurisdictions to protect the integrity of the financial system.

Figure IV.1. Key Pillars of the FATF Recommendations



4. The standards are regularly upgraded to mitigate emerging threats. Since 2018, key changes were related to VAs, beneficial ownership, asset confiscation, risk understanding and mitigation, and data protection.[2] As an observer to the FATF, Fund staff contributes actively to discussions on standard setting, including by bringing issues of macro-relevance to the attention of the FATF membership, as well as highlighting Fund issues to make the standards useful for all Fund members. Together, the FATF, FSRBs, the Fund, and the World Bank periodically assess countries' compliance with the FATF recommendations, as well as the effectiveness of the countries' AML/CFT framework based on the 11 key goals (Immediate Outcomes) that an effective AML/CFT framework should achieve. The assessment calendar is coordinated between all 12 assessor bodies, to ensure that each country is only assessed once during the complete cycle. The FATF Network is currently finalizing the fourth round of assessments; and the fifth round is to commence shortly thereafter.

Virtual Assets and Virtual Asset Services Providers

5. In October 2018 and June 2019, the FATF revised Recommendation 15 on New Technologies, explicitly clarifying that the relevant measures in the FATF Recommendations are applicable to VsA and VASPs.[3] Countries are now required to ensure that the AML/CFT framework

[2] A full list of all updates to the FATF Recommendations since the current standards were issued in 2012 is published in Annex II of the printed PDF version of the FATF Recommendations on www.fatf-gafi.org.

[3] A VA is a digital representation of value that can be digitally traded, or transferred, and can be used for payment or investment purposes. VAs do not include digital representations of fiat currencies, securities, and other financial assets. A VASP means any natural or legal person, and as a business conduct one or more of the following activities or operations for or on behalf of another natural or legal person: (i) exchange between VAs and fiat currencies; (ii) exchange between one or more forms of VAs; (iii) transfer of VAs; (iv) safekeeping and/or administration of VAs or instruments enabling control over VAs; and (v) participation in and provision of financial services related to an issuer's offer and/or sale of a VAs.

covers VAs and that, unless prohibited, VASPs are regulated for AML/CFT purposes, and licensed or registered, and subject to effective systems for monitoring. To support the implementation of the new standard, the FATF issued a report on VAs Red Flag Indicators (September 2020) and an updated Guidance for a Risk-Based Approach to VAs and VASPs (October 2021).

Transparency of Beneficial Ownership

6. In March 2022, the FATF revised its standard on transparency and beneficial ownership of legal persons (Recommendation 24). The updated standard sets out the measures to prevent the misuse of legal persons for ML/TF and other predicate crimes, through the timely availability of adequate, accurate, and up-to-date information on the beneficial owner of legal persons. Among the new measures are the requirement for countries to adopt a registry approach, require companies to know their beneficial owner, require a risk-based approach to foreign legal entities, and prevent bearer shares. The Fund's multi-pronged approach to beneficial ownership transparency is outlined in Box IV.1. It is important to the Fund that an effectively implemented beneficial ownership system also supports other non-AML-related macro-critical policy areas, such as fiscal and procurement transparency, financial sector stability, and CBRs. An example of a new requirement suggested by staff was the requirement to ensure that beneficial ownership information is available to procurement authorities. This is an AML measure that also safeguards public finances, which is of the utmost importance to the Fund.

7. In February 2023, the standard on the transparency of beneficial ownership of legal arrangements (i.e., trusts) was also revised (Recommendation 25). The revision further clarifies the obligations on trustees to obtain and hold adequate, accurate, and up-to-date information related to parties to a trust and indicates that such obligations also extend to persons holding an equivalent position in a similar arrangement. Such trusts and similar legal arrangements include not only (i) those governed under their law, but also (ii) those that are administered in their country or for which the trustee or equivalent resides in their country, and (iii) foreign legal arrangements that have sufficient links to their country.

Box IV.1. The Fund's Approach to Beneficial Ownership Transparency

Transparency of beneficial ownership has become an increasingly important issue that has been raised across all Fund core workstreams. Lack of transparency of beneficial ownership information allows criminals to misuse legal entities (e.g., companies, trusts, and other types of corporate structures) to hide their identities and the criminal origins of their assets. This can produce all sorts of economic distortions (e.g., impact revenue collection, create asset bubbles), negatively impact economic growth, and allow criminals to infiltrate and take control of the legal economy.

Transparency of beneficial ownership can support other Fund work, including to support fiscal transparency and tax collection efforts, tackle IFF, reduce opportunities for corruption, and support transparency and governance measures. Recognizing the importance of transparency of beneficial ownership for financial and economic stability, beneficial ownership issues are raised across all areas of the Fund's core activities, including surveillance, lending, FSAP, CD, and policy work.

Box IV.1. The Fund's Approach to Beneficial Ownership Transparency (Concluded)

The Fund has been at the forefront of policy development in this area. In October 2022, the Fund published *Unmasking Control*, a comprehensive and practical handbook to help Fund members strengthen their beneficial ownership frameworks, in line with the requirements of the new FATF Standards. The guide is based on staff's experience in engaging with member countries and suggests best practices for countries to implement comprehensive beneficial ownership frameworks. Staff has also contributed on beneficial ownership issues in other related Fund publications and outputs, such as the relevance of beneficial ownership for tax in a 2023 Working Paper on leveraging AML measures to improve tax compliance.[1]

As a result of staff's ongoing work, staff has been able to push for important reform of the international standards. Notably, in the context of the revision of the FATF Standards on transparency of legal persons and arrangements, staff successfully pushed for the adoption of a multi-pronged approach to holding beneficial ownership information, including through beneficial ownership registries, and for ensuring that beneficial ownership information is available to procurement authorities, building on staff's experiences with beneficial ownership commitments related to the Fund's emergency lending. Staff also successfully proposed to include foreign companies in the risk assessments and advocated for abolishing bearer shares.

Going forward, staff anticipates increased demand for staff advice and CD in this area. In particular, all countries will be required to make changes to their beneficial ownership frameworks to meet the requirements of the revised FATF Standards. Staff will continue to provide policy advice in this area, including on matters arising from recent developments, and work with other departments in the Fund to maximize the benefits of beneficial ownership transparency beyond AML/CFT across other policy areas (e.g., taxation).

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[1] Mathias, Emmanuel and Adrian Wardzynski. 2023. "Leveraging anti-money laundering measures to improve tax compliance and help mobilize domestic revenues." IMF Working Paper No. 23/83. International Monetary Fund. Washington D.C.

8. The FATF recommendations relating to domestic and cross-border asset recovery are currently under review. Staff is currently contributing to ongoing discussions to support revisions to the standards on asset confiscation (Recommendations 4 and 38). For example, in these discussions, staff is highlighting the potential usefulness of tax enforcement measures to seize and confiscate illicit proceeds, where such powers exist and can be used legally. In addition to the revision of the FATF Recommendations, staff also participates in different policy projects within the FATF Working Groups (e.g., projects on Operational Challenges Associated with Asset Recovery, and Money Laundering and the Illegal Wildlife Trade).

The Fund's Contribution to Assessments

9. AML/CFT assessments remain an important component of the Fund's AML/CFT work program. During the 2018 discussion of the Fund's AML/CFT strategy, Directors reaffirmed that AML/CFT assessments are a key source of information for the Fund's work on financial integrity issues and stressed the importance of ensuring adequate quality and consistency (evenhandedness) of assessment reports across the range of assessor bodies. They encouraged staff to participate actively, as resources permit, in the review mechanisms that had been set up for all assessments to promote quality and consistency. Directors considered it appropriate for staff to conduct one to two Fund-led

assessments per year, in addition to an increased focus on quality and consistency reviews of AML/CFT assessments of other bodies. In addition, Directors requested that staff should be authorized to participate in assessments led by other AML/CFT assessor bodies on an exceptional basis (a decision that was formalized in 2020).

10. AML/CFT assessments are in-depth country reports analyzing the implementation and effectiveness of measures to combat ML, TF, and PF. The reports are peer reviews, where members from different countries assess another country. MEs provide an in-depth description and analysis of a country's AML/CFT system, as well as focused recommendations to further strengthen its system.

11. The burden-sharing arrangements between the IMF, the World Bank,[4] the FATF, and the FSRBs for conducting AML/CFT assessments have generally worked well. Assessors apply a common methodology, and staff and the FATF have collaborated closely in developing and implementing technical assistance and training programs for assessors and assessed country officials. Assessment reports generally provide a sound basis for follow-up technical assistance, and the involvement of multiple assessor bodies has enriched the ongoing discussion on possible improvements of the standard and the assessment methodology. As noted above, assessment calendars are closely coordinated to ensure that every country is only assessed once by the 12 assessor bodies. Moreover, for a staff-led assessment to be recognized as a ME, the country needs to request a staff assessment, and the other assessor body will approve, which further facilitates coordination.

12. Staff has played an active role in the global assessment process. In keeping with the Board's decision for staff to undertake one to two assessments per year, and in line with current staff resources (given how resource intensive each assessment is, on average), staff delivers one assessment[5] per year to FATF/FSRBs. Since each assessment takes more than a year to complete, in practice staff often works on two assessments at the same time (in practice, an assessment takes about 16–18 months, including preparation and publication, and conversion into a report on the observance of standards and codes (ROSC).[6]

13. Not all assessments by all assessor bodies are yet of the same quality and consistency, and staff has been focusing on assisting other assessor bodies to improve their output. While all assessments examine the same issues, there have been notable differences in the quality of the reports from some assessor bodies. In response to these concerns, and in cooperation with the FATF and several of the FSRBs, staff has continued to help strengthen the FSRBs by training their assessors, providing comments on their assessment reports, participating in their plenary meetings, and preparing the authorities of countries about to undergo an assessment, as set out below in more

[4] Due to resource constraints, the World Bank has reduced its contributions to the global assessment process.

[5] It should be noted that in the period under review, the assessment process was paused for almost two years due to the COVID-19 pandemic.

[6] In 2018, Directors also reconfirmed that assessment reports prepared by the FATF and the FSRBs could be converted into AML/CFT ROSCs if requested by the assessed country. For the period under review and as of September 2023, two countries (China and Côte D'Ivoire) requested the issuance of an AML/CFT ROSC.

detail. Many of the relevant assessor bodies have made significant progress in strengthening the quality of their assessments. Nevertheless, improving the quality and consistency of assessment reports remains a work in progress.

The Framework to Ensure the Quality and Consistency of AML/CFT Assessments

14. The quality and consistency processes that had been agreed by the FATF Global Network at the time of the 2018 review of the Fund's AML/CFT strategy are still in force. The framework to strengthen the quality and consistency of assessments aims, *inter alia*, at ensuring the appropriate application of the assessment methodology and procedures across the full range of assessor bodies of FATF, FSRBs, the Fund, and World Bank (also known as the FATF Global Network, or the network) and consists of:

- **Training for assessors:** all assessors must have (among other requirements) successfully undergone a one-week assessor training with a focus on how to assess effectiveness.[7]

- **Country training:** To enable them to prepare successfully for the assessment process, countries are given the opportunity to have relevant stakeholders trained on the assessment process. The training is usually delivered over the course of two days and includes an overview of the standard and of the assessment methodology and procedures, as well as a discussion of how to present information on the effectiveness of AML/CFT measures.

15. Pre-Plenary Reviews: The pre-plenary review consists of two separate measures:

- **External review:** For every assessment, the external reviewers are designated to conduct an in-depth review of (i) the assessment team's draft scoping note (i.e., the note that lays out the areas that assessors will pay increased attention to in the context of the assessment) and (ii) an early draft of the assessment report. The purpose of this measure is to enable independent experts to raise quality and consistency issues before the finalization of the assessment report (e.g., if the analysis is incomplete or does not support the proposed ratings). In some cases, when substantial amendments are made to the draft report based on reviewers' comments, a second more targeted review will take place.

- **Delegations' review:** Prior to their discussion at a Plenary meeting, draft assessment reports are circulated to all delegations for comments. All comments submitted are shared with all delegations. From these comments, five to seven key issues that are relevant for the quality and consistency of the report are selected for discussion by the Plenary. These discussions may result in changes to the reports and provide useful guidance for future reports.

[7] For the fifth round of assessor training, the same structure and general outline as for the fourth-round training. The scope of the training will continue to be a one-week course that will include a combination of presentations covering key aspects of the fifth-round procedures and methodology, interactive discussions, practical exercises, and a mock country evaluation, however, all training materials will be revised and updated, in particular to change the practical exercises and create a new mock country evaluation.

- **Post-Plenary review**: Reports that have been adopted by the FATF or FSRB Plenary are circulated to all delegations throughout the network for a final quality and consistency check, which could lead to having specific issues discussed at the FATF. This additional discussion can result in the report being amended to address the quality and consistency issues prior to publication.

The FATF's High-Risk and Other Monitored Jurisdictions

16. A key objective of the FATF and FSRBs is to assist jurisdictions with significant deficiencies in their AML/CFT regimes and to work with them to address them. This process helps protect the integrity of the international financial system by following up with countries with significant shortcomings identified in their assessment report. Countries commit to an action plan, and work with FATF members and regional peers to improve the effectiveness of the system in key identified areas. The FATF publishes the list of countries that it is working with and publicly reports on their progress or lack thereof in some cases (the FATF gray list or ICRG list). The publicity puts pressure on policy makers in the identified jurisdictions to address their deficiencies in order to maintain their position in the global economy, and the gray listing itself can have a negative impact on the economy.[8] Staff works with countries that are at risk of being grey listed, or have already been listed, and provides technical assistance to allow the countries to complete the agreed action plan as quickly as possible.

17. Jurisdictions enter the review process as a result of its assessment results, but a more risk-based focus to identifying countries would be useful. After qualifying for the process, the country has one year to address the identified issues. The FATF then prioritizes the review of those countries with more significant financial sectors (US$5 billion or more in financial sector assets). Staff supports a more risk-based approach to this process, for FATF to be able to focus on countries that indeed pose a risk to the international financial system, rather than focusing mainly on ratings and a single financial sector assets indicator.[9] During the review process, the FATF considers the strategic AML/CFT deficiencies identified both in terms of technical compliance and effectiveness of measures in place, and any relevant progress made by the jurisdiction. If the FATF deems the progress insufficient to address its strategic deficiencies, the FATF develops an action plan with the jurisdiction to address the remaining strategic deficiencies. For all countries under ICRG review, the FATF requires a high-level political commitment that the jurisdiction will implement the legal, regulatory, and operational reforms required by the action plan.

[8] The Impact of Gray-Listing on Capital Flows: An Analysis Using Machine Learning (imf.org)

[9] The FATF reviews jurisdictions based on threats, vulnerabilities, or particular risks arising from the jurisdiction. Specifically, a jurisdiction will be reviewed when (i) it does not participate in an FSRB or does not allow ME results to be published in a timely manner; (ii) it is nominated by a FATF member or an FSRB. The nomination is based on specific ML, TF, or PF risks or threats coming to the attention of delegations; or (iii) it has achieved poor results on its ME, specifically: it has 20 or more Non-Compliant (NC) or Partially Compliant (PC) ratings for technical compliance; or it is rated NC/PC on three or more of the following Recommendations: 3, 5, 6, 10, 11, and 20; or it has a low or moderate level of effectiveness for nine or more of the 11 Immediate Outcomes, with a minimum of two lows; or it has a low level of effectiveness for six or more of the 11 Immediate Outcomes.

18. The FATF publishes two statements at the end of each plenary meeting, in February, June, and October. These statements provide a short summary of the recent actions taken in accordance with each jurisdiction's action plan, as well as a list of the strategic deficiencies remaining to be addressed. The two statements reflect FATF's assessment of the different levels of risk posed at any given time by the deficiencies in the jurisdictions under review. In order to be removed from FATF monitoring, a jurisdiction must complete its action plan. Once the FATF has determined that a jurisdiction has done so, it will organize an onsite visit to confirm that the implementation of the necessary legal, regulatory, and/or operational reforms is underway, and there is the necessary political commitment and institutional capacity to sustain implementation. If the onsite visit has a positive outcome, the FATF will decide on removing the jurisdiction from public identification at the next FATF plenary.

19. Staff will continue to monitor developments in the ICRG and to play a "good office" role in relation to the ICRG process. More precisely, staff will continue providing relevant information on member countries under review, while refraining from participation in those aspects of the process that are coercive in nature. In order to help its members exit the listing, staff will continue to provide relevant policy advice in AIV Staff Reports and deploy CD on key areas of vulnerabilities.

C. The Fund's Relation with the Egmont Group

20. As a global organization, the Egmont Group facilitates and prompts the exchange of information, knowledge, and cooperation amongst member FIUs. The Egmont Group is the international organization that brings together 166 FIUs. In many countries, the FIU is also the lead agency on AML/CFT which allows FIUs to be well positioned to support AML/CFT national and international efforts. FIUs are also trusted gateways for sharing financial intelligence domestically and internationally per global AML/CFT standards. The Egmont Group provides FIUs with a platform to securely exchange expertise and financial intelligence to combat ML, TF, and associated predicate crimes. The Egmont Group, named after the famed palace in Brussels, Belgium, where the first meeting took place, is based in Ottawa, Canada and is an observer to FATF.

21. To support the role of FIUs, the Fund developed a strong relationship with the Egmont Group since its inception. Staff attends the Egmont Group plenary and working group meetings, coordinates its CD activities to FIUs with the Group, and engages on analytical work to highlight key best practices and challenges facing the work of FIUs.

The Role of FIUs on AML/CFT Issues—Importance and Background

22. FIUs have been playing a leading role in the fight against financial crimes around the globe. Their unique role in bridging the intelligence gap between the financial sector and criminal justice authorities like law enforcement agencies (LEAs) and the prosecution make them a foundational agency in the pursuit of money launderers and the financers of terrorism. Under the FATF Standards, FIUs act as a national center for the receipt and analysis of suspicious transaction reports and other information from both the private and public sector relevant to ML, associated

predicate offenses, and TF, and for dissemination of the results of that analysis to investigative authorities.

23. FIUs are governed internationally by the rules established by the Egmont Group[10] (to the extent that they have attained membership in the group) as well as the FATF's 40 Recommendations. The Egmont Group also develops guidance and research products for FIUs with respect to emerging FIU issues. The Egmont Centre of FIU Excellence and Leadership also produces training and promotes sharing of best practices among FIUs. The international standard for FIUs is the FATF Standards, notably Recommendation 29, and it applies to all countries, irrespective of Egmont Group membership.

Challenges Facing FIUs

24. Despite the wide access of information and the support given to FIUs under the FATF Standards and through the Egmont Group and the Fund, assessment reports in the FATF's fourth round of MEs showed many challenges affecting FIUs' ability to conduct their core functions effectively. Particularly, the reports indicated several cases of lack of understanding of key ML and TF risks at the FIU level in member countries which affected their abilities to tailor their operational and strategic analysis activities according to these risks. In other cases, where FIUs were able to understand the major ML threats in their countries, they did not have a similar understanding of TF and PF threats which negatively affected their ability to mitigate these risks.

25. Another major challenge may arise from the way FIUs are structured in the overall national AML/CFT institutional framework. Insufficient autonomy coupled with weak governance, or lack of proper access to key sources of information resulted in weak FIUs that were not able to effectively contribute to developing strong financial intelligence to support successful investigations or achieving the proper deterrence to financial crimes. A lack of follow up by law enforcement and prosecution on intelligence products from the FIU is another issue that has been observed. In many cases, key sectors (particularly some types of DNFBPs) submitted low levels of reports to the FIU. Additionally, in some countries, limited FIU resources and poor physical infrastructure are detrimental to ensuring proper and secure handling of intelligence information, which in turn affects the confidence of other stakeholders and their willingness to cooperate and share information with the FIU.

26. The diverse roles being pursued by FIUs present additional challenges. One example includes FIUs having AML/CFT supervisory responsibilities over financial institutions, DNFBPs, or non-profit organizations (NPOs)[11] without having sufficient resources or adequate legal requirements for conducting and enforcing these activities. This usually leads to more pressures on the FIU's core functions and in lower quality supervision either due to lack of sufficient financial resources, supervisory expertise, or the proper legal tools to monitor and enforce for compliance failures.

[10] For example, the Egmont Principles for Information Exchange between Financial Intelligence Units (July 2013).

[11] The FATF Standards do not require NPOs to be supervised or to be designated as reporting entities.

27. Finally, a fundamental feature for effective FIUs is their access to foreign financial intelligence. Such access is often provided through effective international cooperation mechanisms and most importantly through their membership in the Egmont Group and their access to the Egmont Secure Web. Several FIUs around the world are still at an early stage of development, are still not members of the Egmont Group, and require assistance to bring their operations in line with the Egmont membership requirements to avail themselves of the benefits of being a part of the Egmont network.

The Fund's Current CD Engagement on FIU Issues

28. AML/CFT CD delivered by staff focuses on countries that have weak frameworks and lowest levels of technical capacity. Staff is engaged in projects to support the capacity of FIUs (e.g., Namibia, Suriname, Tajikistan, Timor-Leste, Vietnam, and Yemen). Assistance ranges from the review of AML/CFT laws and the governance, role and responsibilities of FIU, review of operating procedures and guidance, and implementation of risk-based supervisory systems. The establishment of FIUs in these countries is particularly critical to identify IFF that may result from ML related to corruption and other offenses, and to pursue proceeds of crime that may be laundered both locally and internationally. Recovery of such proceeds assume critical relevance in FCS, where governments can ill-afford to lose revenue needed for national development. In addition, countries with weak AML/CFT frameworks (when taken together with other geo-political and socio-economic factors) are also at increased risks of TF. In such countries, the FIU must also take a leading role in addressing such risks, given the gravity of the consequences.

Fund Policy Advice Related to FIUs Under Surveillance

29. Fund surveillance for such countries has consistently emphasized the need to strengthen the role of FIUs given their critical role in the AML/CFT frameworks of member countries, particularly in cases where FIU reforms have been weak or delayed.[12] FIUs currently outside of the Egmont Group network rely on the FIUs of existing members countries to sponsor and assist them in establishing a national FIU that meets the standards for Egmont membership, which includes suitable legislative frameworks that clearly establishes the FIU's independence and autonomy as well as adequately providing for its function, responsibilities, and powers. Attention is also usually paid to the physical facilities and the operational procedures in place.

30. Recent emerging challenges facing FIUs are related to the virtual sector and processing of big data. FIUs often do not have the capacity to deal with new technological developments (such as VA transactions) and tracing funds movements which require more advanced tools. Other challenges also include the need to manage large amounts of data from financial institutions and DNFBPs and having the proper platforms and tools to deal with large amount of data.

[12] See for example second review of the Staff Monitored Program staff reports for Haiti (2023), and AIV staff report for South Sudan (2022), Timor-Leste (2022), Djibouti (2022), and Guinea (2021).

The Way Forward

31. Given the Fund's longer-term CD engagement with members together with its lending and surveillance activities, the Fund is well placed to assist countries in effecting meaningful reforms in strengthening the role of FIUs. Staff, in coordination with Egmont Group, will continue focusing on the area of establishing appropriate legislative frameworks that can support the role of FIUs including in accessing Egmont membership, paying particular attention to the areas of FIU independence, autonomy, and governance. Staff has extensive experience and comparative advantage in this area benefiting from knowledge gained in strengthening the governance of central banks, supervisors, revenue administrations, and supreme audit institutions.

32. Staff worked with member countries to build FIU capabilities to differentiate classes of intelligence and to build useful intelligence for successful financial investigations. Past examples include Kuwait (establishing the FIU and enhancing its capacity), Guinea (provision of advice to strengthen the FIU's structure, analytical processes, risk understanding, and financial intelligence products), Bhutan (drafting of an operating procedures manual, together with training on implementation) and Cambodia (development of a procedures manuals and delivery of training on FIU functions in collaboration with the UNODC). The enhancement of capacity also assists in building trust within the law enforcement agency community so that information is shared both ways in addition to building trust in the financial sector to ensure STRs are dealt with promptly and with confidentially. FIUs that benefited from the Fund's CD were more able to have access to the right type and quality of information from reporting entities and domestic agencies (e.g., law enforcement, administrative information) and were able to identify the prevailing typologies and trends and use them to properly guide reporting entities.

33. The Fund's partnerships with other agencies involved in FIU CD such as the Egmont Group, UNODC, and other donors (e.g., U.S, Australia) can also assist delivering quality CD to FIUs. In 2023, the Fund published a book on CFT that was developed in close collaboration with the UN, Egmont Group, INTERPOL, and Europol. One chapter focuses on the production and use of financial intelligence by FIUs to counter-terrorism and TF, and another discusses international cooperation efforts in CFT including through the exchange of information by FIUs. An example of future collaboration is the planned updating of the Legal Department's FIU Handbook (initially published in 2012) in collaboration with the Egmont Group. This handbook will be updated to reflect the newer challenges for FIUs and recommend best practices and is intended as a resource for FIUs both advanced and those at an early stage of development.

BACKGROUND PAPER V: FEEDBACK FROM STAKEHOLDERS

Executive Summary

This background paper provides detailed results from staff's consultations with internal and external stakeholders on the Fund's AML/CFT strategy. The consultation involved the Fund's departments, country authorities, international and regional organizations (IROs), and CSOs and included online surveys and in-person meetings. Consultations indicate that stakeholders broadly view the Fund's AML/CFT engagement as aligned with members' ML and TF risk and context. Deeper, risk-based coverage of these issues in Fund workstreams and improved understanding of macroeconomic impacts of financial integrity issues are identified as key areas to improve the effectiveness of the work program going forward. To this end, respondents suggested that staff should continue to strengthen engagement with both internal and external stakeholders.

A. Overview[1]

1. Staff held detailed consultations with internal and external stakeholders to collect feedback on the Fund's AML/CFT work program for the review period. The Fund's area and functional departments, country authorities, international and regional organizations, and CSOs participated in the consultations. Stakeholder input was collected through tailored surveys and supplemented by informal consultations with Fund departments and CSOs. 137 Fund country teams, 77 countries, 24 IROs[2] and 14 CSOs responded to the staff survey.

2. Stakeholders had overall positive views on the implementation of the Fund's AML/CFT program for 2018-2022. Across all surveys, a majority of stakeholders found the Fund's coverage of AML/CFT issues in surveillance and lending to be appropriate and in line with the ML/TF risks faced by members. Respondents also had favorable responses on the usefulness of the Fund's CD engagement and the effectiveness of its contributions to the global policy agenda.

3. Common themes emerge in stakeholders' proposals for the way forward. Key messages from stakeholder consultations are summarized in Table V.1. Despite the differences in their engagement with the Fund on AML/CFT issues, some common **themes** appear in stakeholders' proposals for the way forward. For instance, respondents agree **that** the Fund should focus on AML/CFT issues with macroeconomic significance and call for greater use of ML/TF risk information to tailor coverage of issues in Fund workstreams. Survey results also indicate that respondents are aligned in thematic priorities for future AML/CFT coverage: for instance, illicit financial flows and beneficial ownership transparency were identified among thematic priorities by the Fund's area

[1] Prepared by Emilia Berazategui (COM), Miho Tanaka, Kristina Miggiani, and Indulekha Thomas (all LEG)

[2] The IROs survey had a 100 percent response rate with all IROs working on AML/CFT and adjacent issues participating in the survey.

departments, country authorities, IROs and CSOs. All stakeholders also call for further enhancing internal and external coordination, through ongoing engagement and information exchange between LEG and area departments and strategic cooperation with external stakeholders. Granular responses from internal and external consultations are summarized in sections A to D.

Box V.1. Key Messages for the Way Forward

Key themes in feedback	Mission chiefs	Country authorities	IROs	CSOs
On the direction of future coverage	Increase integration of AML/CFT issues in the Fund's policy advice through improved understanding of macroeconomic significance of AML/CFT reforms. Improve tailoring of coverage to country circumstances and avoid proforma coverage.	Increased focus on the Fund's advantage (e.g., financial flows analysis) and deeper exploration of the connections between AML/CFT and financial stability and the macroeconomy.	Continue focus on macro-criticality of AML/CFT issues. Strengthen surveillance through greater use of risk & context data (including from other workstreams). Continue active role in assessments, including through trainings and quality and consistency reviews.	Greater focus on IFFs and their impacts on financial stability and the broader economy. Deeper coverage of AML/CFT issues in AIVs and FSAPs for IFCs where AML/CFT weaknesses can have spillover effects.
On thematic focus areas for future coverage	Illicit financial flows (IFFs), beneficial ownership transparency, financial integrity considerations associated with fintech/digital money, and correspondent banking pressures from AML/CFT weaknesses among key thematic priorities for future engagement.	Continue emphasis on themes including beneficial ownership transparency, IFFs, and fintech and digital money, especially through CD for countries with capacity constraints.	Greater thematic focus on beneficial ownership transparency, IFFs, fintech and digital money, financial and tax transparency standards, and asset recovery.	Greater emphasis on public access to beneficial ownership information across all sectors. Promotion of cooperation between AML/CFT and tax and greater focus on proceeds of predicate crimes such as corruption and environmental crimes.
On cooperation with stakeholders	Ongoing engagement with area departments and continuous information exchange key for effective coverage.	Continue strengthening cooperation with FATF/FSRBs and other IROs and avoid duplication of work.	Move from ad hoc coordination to strategic cooperation with IROs based on common priorities and objectives.	Regular and close engagement with national and global CSOs and greater transparency of the Fund's CD, particularly outcomes of the Fund's engagement.

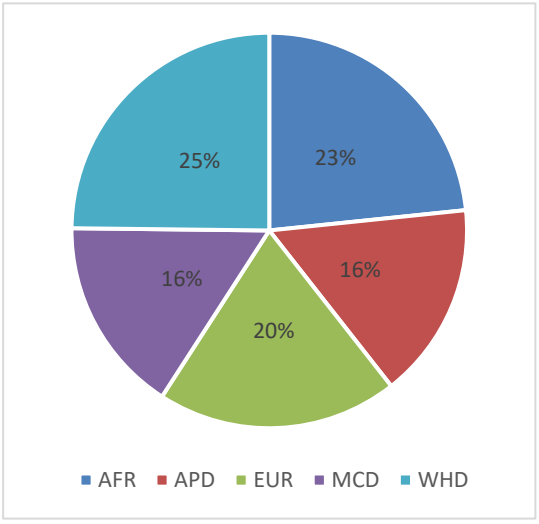
B. Survey Responses from Fund's Mission Chiefs

4. LEG extensively engaged with the Fund's functional and area departments through informal discussions and surveys. Area departments, Africa (AFR), Asia Pacific (APD), Europe (EUR), Middle East and Central Asia (MCD), and Western Hemisphere (WHD) as well as functional departments (Strategy, Policy, and Monetary and Capital Markets (MCM)), participated in the informal consultations and a total of 137 mission chiefs responded to the survey. Respondent breakdown and response rate per department are set out in Figure V.1. The survey shows broad engagement across country team workstreams. During the period under review (2018–2022), 42 percent of the respondents have engaged on AML/CFT issues in surveillance, 14 percent in lending, and 28.5 percent in both surveillance and lending, while 6.6 percent note engagement in all three workstreams (lending, surveillance, and CD).[3]

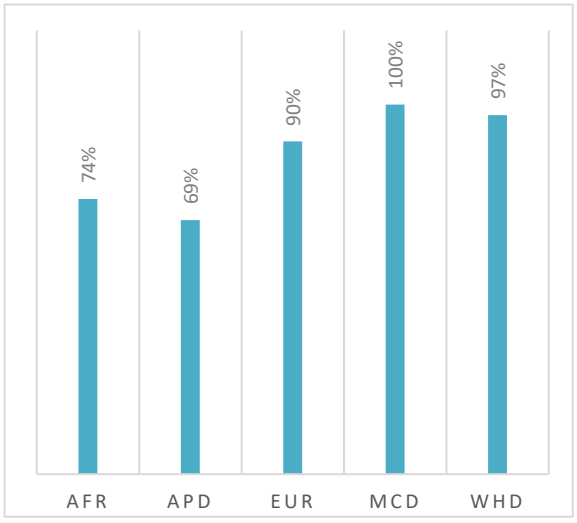
5. Country teams' feedback generally supports that the AML/CFT engagement has been aligned with member countries' ML/TF risks and guided by the 2018 AML/CFT strategy. Survey respondents broadly agreed (with over 75 percent of respondents in agreement)[4] that the coverage of AML/CFT issues across all workstreams was appropriate given the ML and TF risks faced by member countries. Similarly, respondents also noted that the AML/CFT work program is guided by the 2018 AML/CFT strategy (with over 80 of respondents in agreement). This broad agreement is reflected across different area departments (Figures V.1 and V.2).

Figure V.1. Composition of Respondents

Respondent composition by department



Response rate per department

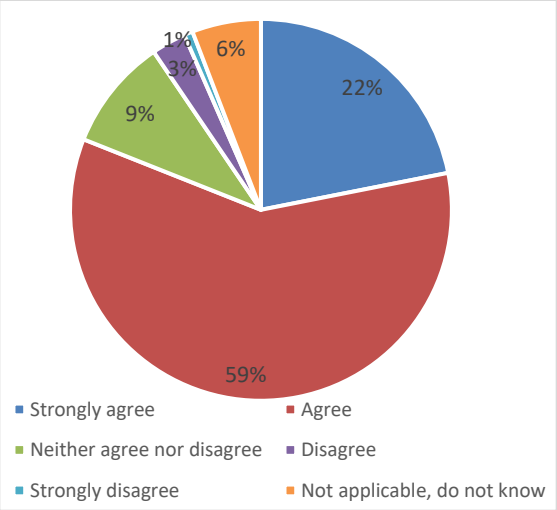


[3] One respondent noted AML/CFT engagement only related to CD.

[4] This includes mission chiefs who responded 'agree' or 'strongly agree' to Q5.

Figure V.2. Q4. The Work of the Fund on AML/CFT is Guided by the Review of the Fund's Strategy on AML/CFT Adopted in November 2018 and the Press Release of February 2019

(*in percentage of total respondents*)



(*by departments*)

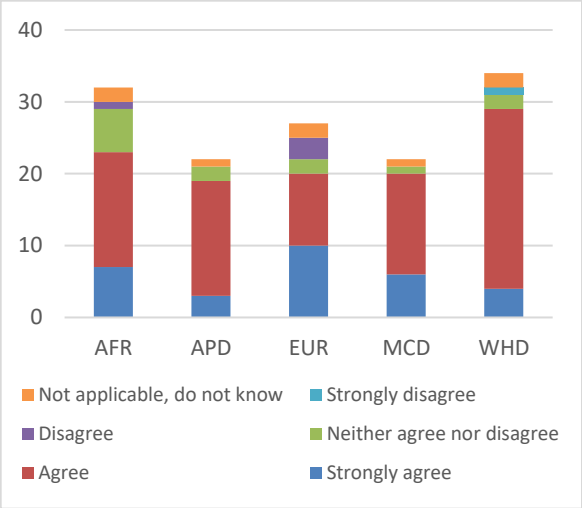
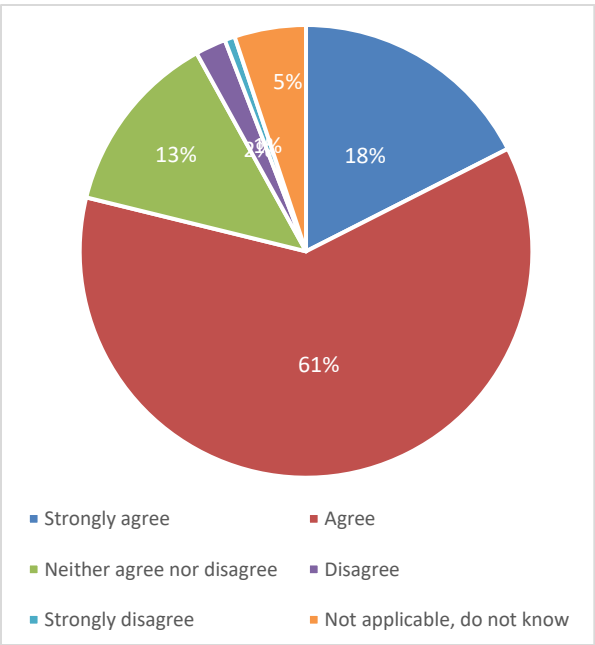
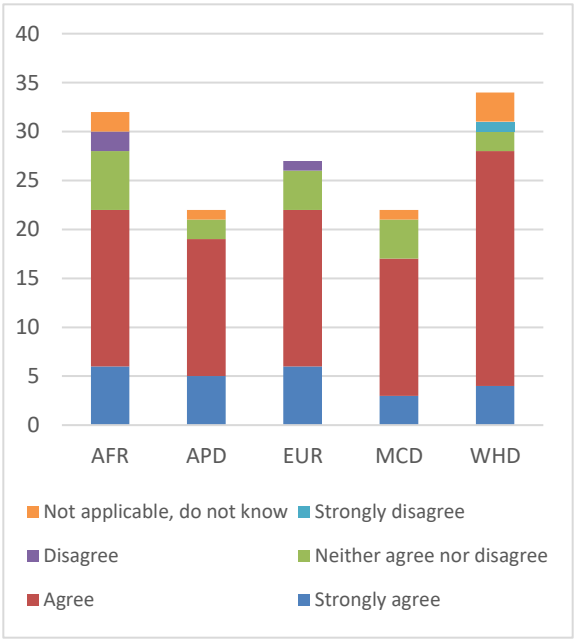


Figure V.3. Q5. The Coverage of AML/CFT Issues in all Workstreams is Appropriate Considering ML, TF, and Broader Financial Integrity Risks Faced by Member Countries.

(*in percentage of total respondents*)



(*by departments*)



6. Departmental consultations also highlight the need for greater tailoring in coverage based on an improved understanding of macro-critical impacts of financial integrity issues. Some country teams expressed concern that coverage of AML/CFT issues in Fund workstreams is superficial and over-reliant on FATF and FSRB assessments. Several respondents noted that an improved understanding of the macroeconomic significance of AML/CFT reforms would allow improved integration of these issues in overall policy advice in surveillance and build a stronger case for inclusion of AML/CFT conditionalities in programs. For instance, one respondent called for a better understanding of how AML/CFT gaps may act as transmission channels to macro-financial shocks, and/or hamper growth and economic development, or generate vulnerabilities in the financial system, to improve future coverage of AML/CFT issues in Fund workstreams. Thematically, stakeholders identified the analysis of IFF and combatting of ML in their destination jurisdictions, financial integrity considerations associated with Fintech/digital money, and correspondent banking pressures from weaknesses in AML/CFT frameworks as key priorities for future engagement.

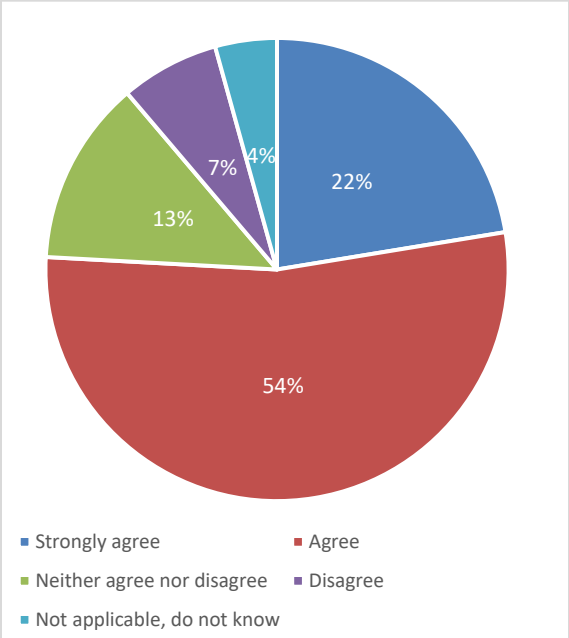
7. On engagement modalities, consultations highlight that ongoing engagement between LEG and area departments on AML/CFT issues is key to allow appropriate coverage. Country teams expressed appreciation for LEG's support through mission participation, input to staff reports, bilateral meetings, and interdepartmental reviews. A majority of respondents specifically noted that LEG's virtual participation in missions was beneficial in leading the discussions on AML/CFT, while a few highlighted that in-person participation in the mission discussions would often be preferable given the sensitivity of the issues discussed, particularly on lending. Overall, consultations highlighted that an established relationship between LEG and the relevant country teams and sharing of information on a continuous basis are most conducive to effective coverage. Engagement limited to provision of comments during interdepartmental review was least beneficial, since the comments and input came too late to be appropriately discussed with the authorities and integrated in the staff report.

Surveillance

8. The consultations broadly indicate that AML/CFT issues have been appropriately covered in AIV surveillance. Over 70 percent of total respondents positively viewed engagement of AML/CFT issues in AIV surveillance and agreed that this coverage was well supported by LEG. Similarly, high trends in positive responses were observed across all surveyed area departments (Figure V.4). Several country teams appreciated instances of tailored coverage of AML/CFT issues in departmental consultations, particularly where the coverage was aligned with and informed by findings from ongoing AML/CFT technical assistance (e.g., inclusion of findings from the Nordic-Baltic technical assistance in the 2022 Lithuania AIV consultation).

Figure V.4. Q8. Over the Past Years, AML/CFT Issues are Appropriately Covered in AIV Staff Reports (i.e., when AML/CFT Issues Affect, or Have the Potential to Affect, Domestic or Balance of Payments or External stability).

Overall (in percentage of total sample)



(*by departments*)

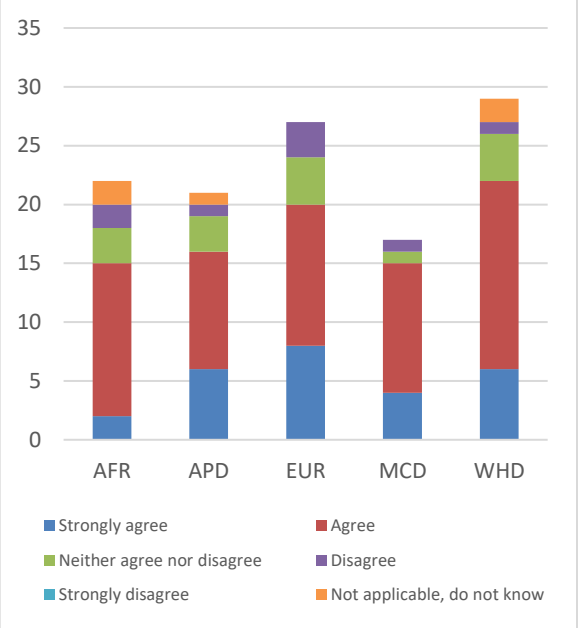
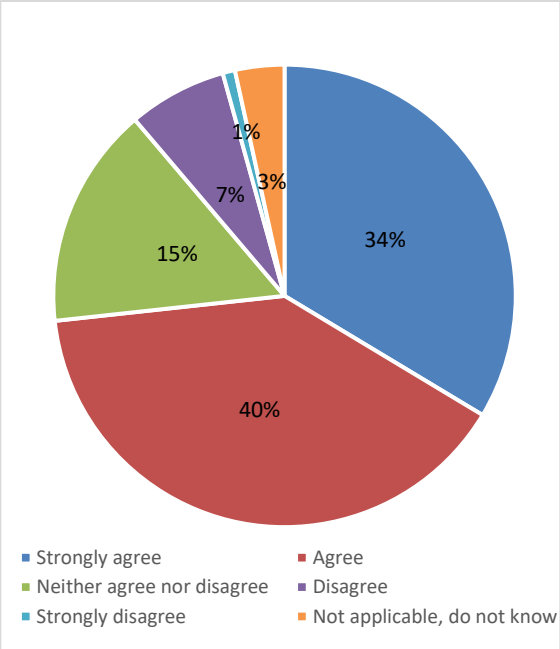
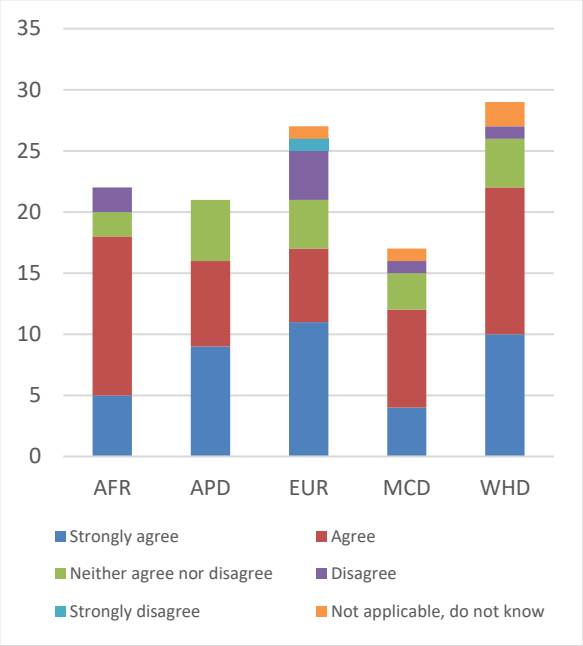


Figure V.5. Q10. In Surveillance, Coverage of AML/CFT Issues is Appropriately Supported by LEG Staff (e.g., Onsite Missions, HQ Support)

Overall (in percentage of total sample)



(by departments)



9. Mission teams called for deeper analysis of AML/CFT issues in future AIVs with closer linkages with other macro-priorities. Departmental discussions and survey responses reflected a concern that AML/CFT coverage is sometimes boilerplate (based on FATF's assessments) and disconnected from other policy advice in AIVs. Several country teams called for alignment of coverage of AML/CFT issues with other macro-critical priorities, for instance, increasing linkages between AML/CFT and issues such as governance and anti-corruption, fiscal revenue collection, and financial sector and access to global financial markets, respectively.

10. Similarly, consultations indicate that AML/CFT engagement in FSAPs is appropriate, with more forward-looking coverage encouraged going forward. Discussions with MCM indicate that AML/CFT discussions during FSAPs were relevant to the country's ML/TF risks and the broader context of its financial sector and were complementary to the findings and recommendations across other areas. MCM mission chiefs also broadly agreed that AML/CFT recommendations in FSAPs were tailored, useful, and implementable. Some mission chiefs cautioned against adopting a backward-looking, checking-the-box approach reliant on FATF assessments, and called for tailored coverage with greater synergies with discussions on financial sector oversight.

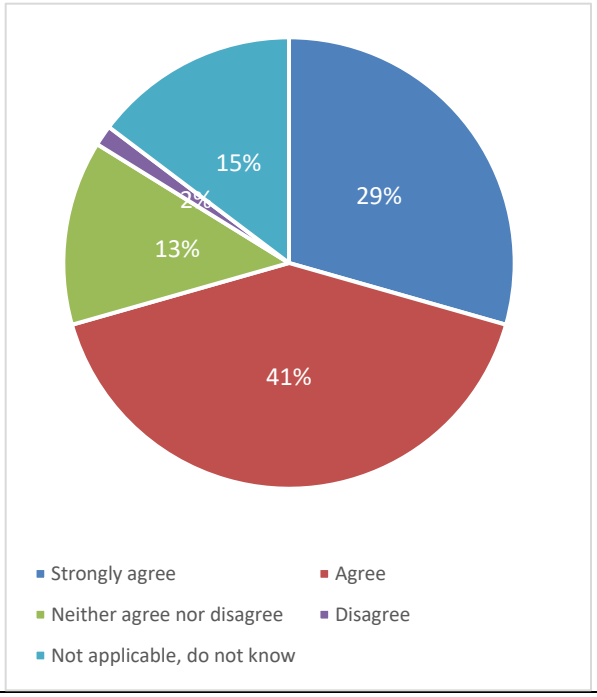
Lending

11. AML/CFT related conditionality have been included in Fund-supported programs where critically important to achieve program objectives, as highlighted by over 70 percent favorable responses (Q13). Notably, country teams' views on AML/CFT coverage in programs are derived from a smaller sample as only around 50 percent of the total respondents have engaged in AML/CFT issues in Fund-supported programs during the period under review. Country teams also appreciated LEG's support for AML/CFT coverage in lending (over 75 percent favorable responses), with several respondents noting a preference for LEG's mission participation. Despite the smaller pool of respondents, consultations and survey responses indicate greater traction for AML/CFT reforms in lending as compared to surveillance. In particular, qualitative responses highlighted instances where LEG's support on AML/CFT issues helped achieve further program objectives as well as significant reforms in AML/CFT frameworks (e.g., Haiti, Pakistan).

12. At the same time, a few stakeholders called for evenhandedness in inclusion of AML/CFT conditionality across Fund-supported programs and emphasized the need to avoid cross-conditionality. Some country teams indicated that AML/CFT related conditionality were greater in countries exporting IFF and noted the need for greater inclusion of such conditionality in transit and destination countries for such flows, where Fund-supported programs were negotiated. On precautionary lending, respondents stressed the need for the Fund's independent assessment of AML/CFT issues, informed by but separate from the FATF network's assessments of AML/CFT frameworks. They noted potential reputational risks from cross-conditionality in Fund-supported programs, particularly conditionality tied to the achievement of the FATF action plans items.

Figure V.6. Q13. When AML/CFT Weaknesses are Assessed as Severe and Critically Important for Achieving the Goals of a Fund-Supported Program, Specific AML/CFT Measures Have Been Incorporated as Conditionality in Fund-Supported Programs

Overall (in percentage of total sample)



By departments

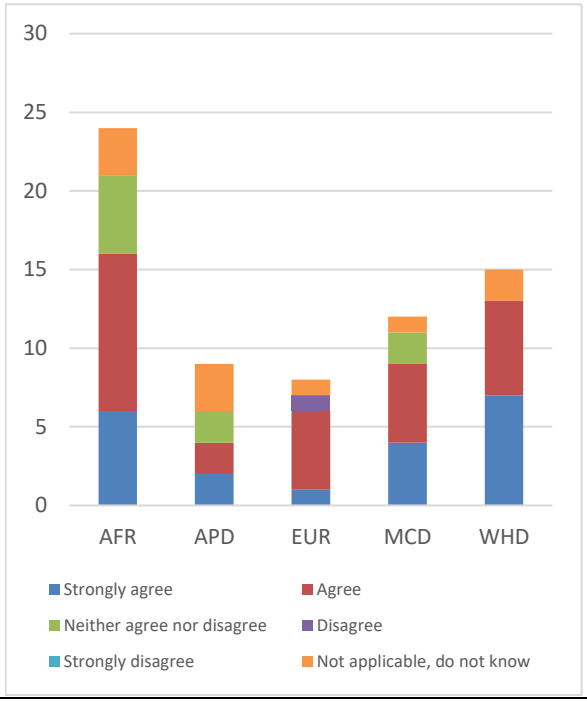
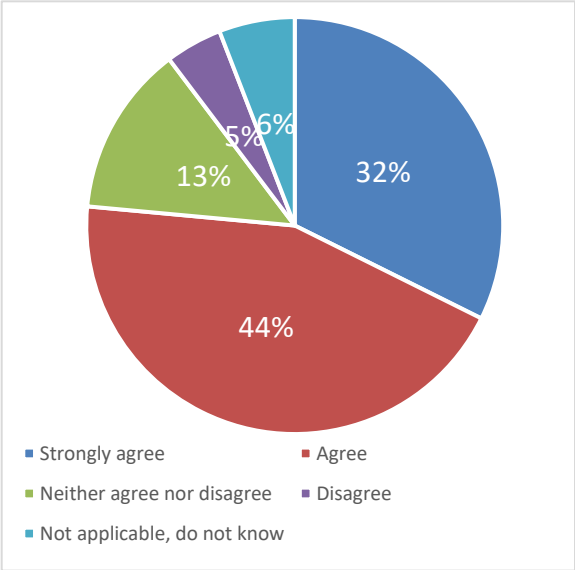
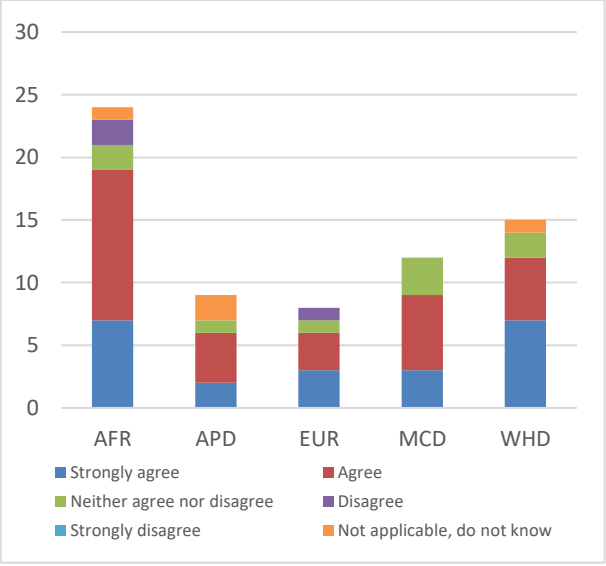


Figure V.7. Q14. In Fund-Supported Programs, Coverage of AML/CFT Issues is Appropriately Supported by LEG Staff (e.g., Onsite Missions, HQ Support)

Overall (in percentage of total sample)



By departments



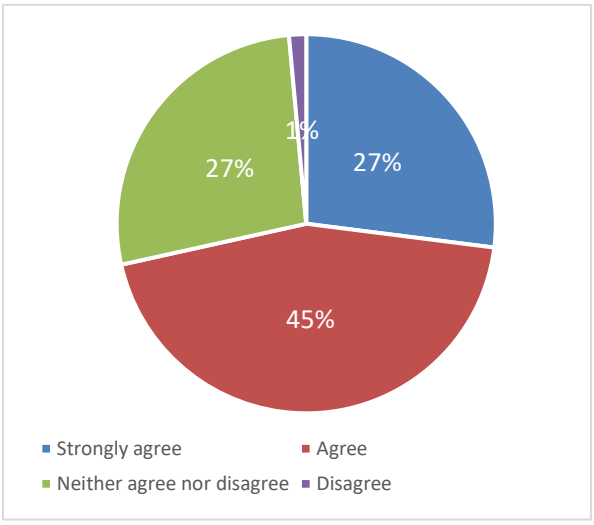
CD

13. Country teams expressed broad appreciation for AML/CFT-related CD (Qs. 18, 24, 25). A majority of survey respondents considered AML/CFT-related CD to be useful to the recipient countries to support efforts to strengthen AML/CFT frameworks. These positive findings were echoed by survey respondents of countries where the Fund provided AML/CFT-related CD. Capacity constraints for competent authorities and limited political will were perceived as hurdles for implementation of CD advice.

Figure V.8. The Recommendations from AML/CFT CD are Useful to Countries (Q24) and Supported Countries' Efforts to Strengthen their AML/CFT Regime (Q25)

that AML/CFT CD advice is useful…

(*in percentage of total respondents*)



and supports strengthening AML/CFT frameworks

(*in percentage of total respondents*)

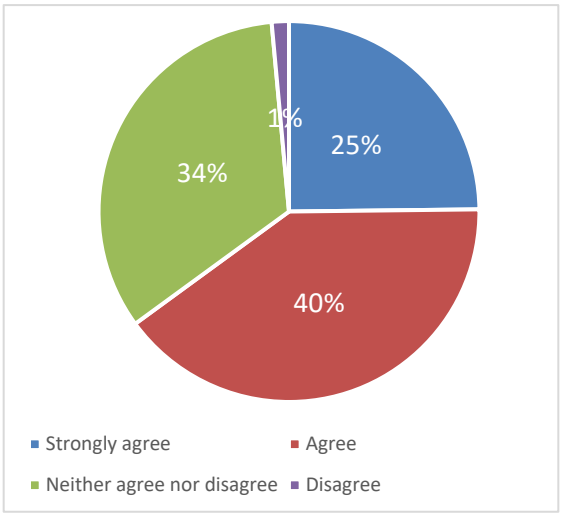
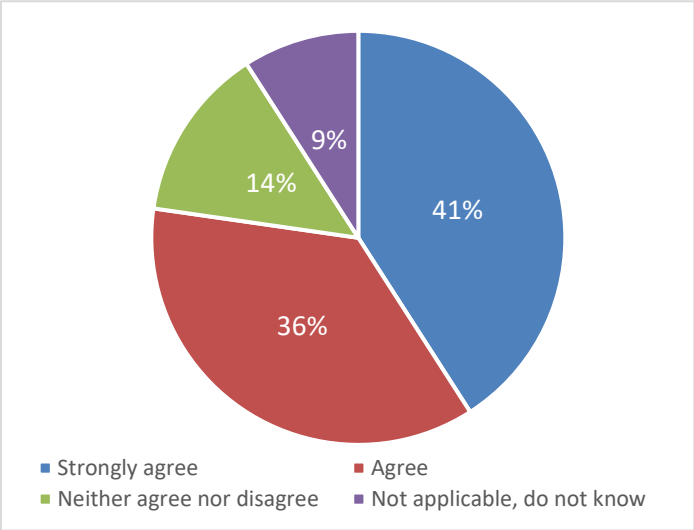


Figure V.9. Q18. The Fund's CD on AML/CFT was Appropriate and Useful for the Authorities to Implement AML/CFT Reforms

(*in percentage of country teams for CD recipients*)



14. Country teams highlighted the need for greater synergies between CD and surveillance and lending. In surveillance, country teams explicitly noted benefits from drawing on findings from AML/CFT CD to deepen surveillance and called for sharing of findings from CD projects with country teams on an ongoing basis. In lending, departmental discussions and survey responses underlined that technical assistance is often necessary to help countries implement AML/CFT reforms and called for swifter mobilization of technical assistance to aid implementation of AML/CFT-related conditionality.

C. Survey Results from Country Authorities

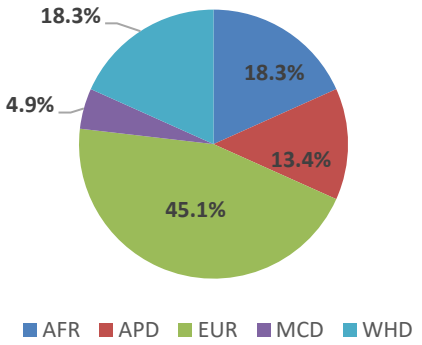
15. Staff circulated a survey to all member countries to collect feedback from member countries on the Fund's AML/CFT engagement under the review period. Eighty-two authorities from 77 countries—40.5 percent of the Fund's membership—responded to the survey. By regional departments, 15 responses were received from AFR, 11 from APD, 37 from EUR, four from MCD, and 15 from WHD. By income levels, 32 authorities from advanced economies ((AE) based on World Economic Outlook (WEO) basis), 35 from emerging markets (EM), and 15 from LIC (based on poverty reduction and growth facility (PRGT) eligible countries) responded to the survey. There were four responses from FCS, based on the World Bank's list of FCS. Countries listed as such in FY2019 to FY2022 are counted as FCS. Sixty-four have participated in surveillance, 50 have undergone FSAP, 15 have received Fund-supported programs/emergency lending, and 39 have benefited from the Fund's CD activities during the last five years.

16. Overall, respondents welcomed the Fund's targeted approach in surveillance and FSAPs guided by the country's ML/TF risks. They emphasized the need for an increased focus on the Fund's advantage, such as financial flows analysis and a deeper exploration of the connections

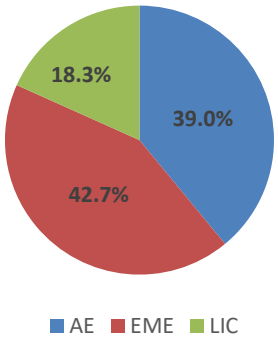
between AML/CFT and the macroeconomy and financial stability. Country authorities noted the positive impact of AML/CFT-related conditionalities in Fund-supported programs on their AML/CFT framework's effectiveness. They found the Fund's CD program useful, particularly regional and thematic projects. Respondents underscored the importance of coordination with the FATF/FSRBs to leverage synergies and prevent duplication of work, and some called for an increase of the number of Fund-led assessments. Further, respondents encouraged the Fund's continued emphasis on thematic areas, including beneficial ownership transparency, Fintech/digital money, and VAs.

Figure V.10. Respondents from Country Authorities

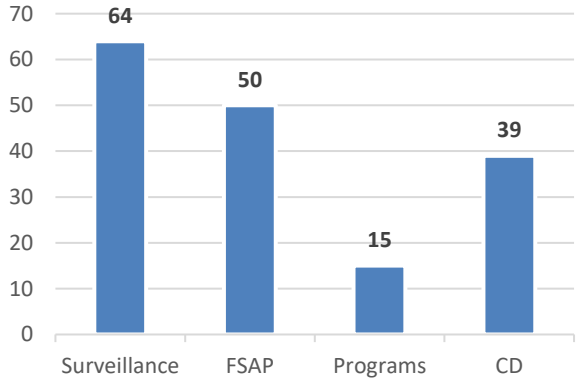
By region (in percent of the total sample)



By income level (in percent of the total sample)



Types of engagement with the Fund in the last five years (The number of respondents engaged in each workstream, multiple-choice)



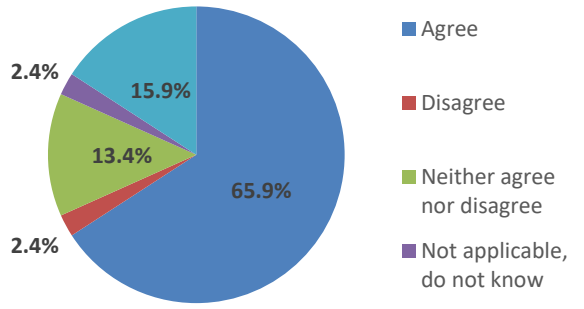
Source: Country authorities survey.

17. County authorities found that the Fund's engagement on AML/CFT issues across different workstreams is appropriate. Fund engagements addressed ML/TF and broader financial integrity risks faced by the respondent's country (Q1). Respondents welcomed the Fund's targeted approach on the country's key ML/TF risks (Q2) and good coordination with the FATF. The Fund's AML/CFT assessments provided useful and implementable advice for regulators and policy makers (Q3).

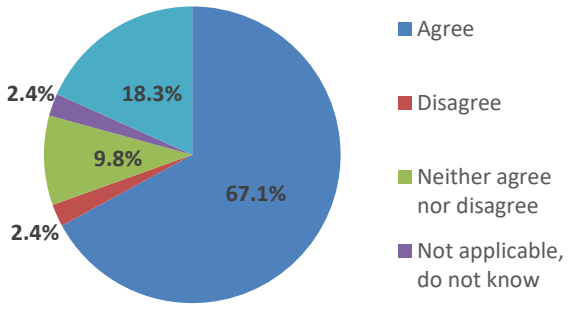
Figure V.11. Overall Effectiveness of the Fund's Engagement on AML/CFT Issues

The Fund's engagement on AML/CFT issues including across different workstreams (i.e., surveillance, Fund-supported programs, FSAP, assessments, CD) is appropriate in addressing the ML, TF, and broader financial integrity risks faced by your country.

The work of the Fund on AML/CFT is guided by the review of the Fund's strategy on AML/CFT adopted in November 2018 and the press release of February 2019 (Q1). (in percent of total sample)



In the context of your engagement with the Fund, the Fund focused appropriately on the AML/CFT issues that are most relevant to your country's ML and TF risk and context (Q2). (in percent of total sample)



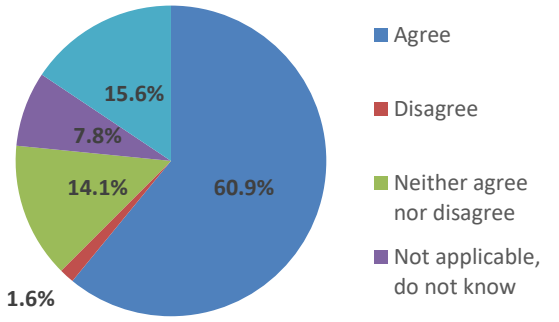
Source: Country authorities survey.

Surveillance

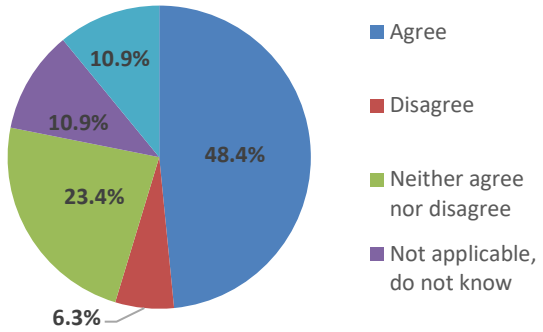
18. On surveillance, country authorities perceive the AML/CFT issues to be appropriately covered in AIV Staff Reports when those issues are macro-critical (Q4). The majority of the respondents agreed that the Fund's AIV staff reports provided tailored, concrete, and granular advice to address ML/TF risks and AML/CFT vulnerabilities (Q5). Authorities welcomed the targeted coverage and feedback in line with the countries' ML/TF risks and the timely update of the countries' latest AML/CFT measures in the staff reports. Notably, one of the respondents appreciated the discussion on the risk of cross-border ML/TF based on the analysis of SWIFT data. Key suggestions included greater focus on the linkage between AML/CFT and macroeconomic/financial stability, more specific and detailed policy advice (e.g., more granular advice on specific sectors, technical discussions on risk-based approach), and closer communication with the assessed countries in developing policy advice (Q6).

Figure V.12. Surveillance

Since 2018, AML/CFT issues are appropriately covered in AIV Staff Reports (Q4). (in percent)[1]



The Fund's AIV Staff Reports provided tailored, concrete, and granular advice to address ML/TF risks and AML/CFT vulnerabilities (Q5). (in percent)



Source: Country authorities survey.

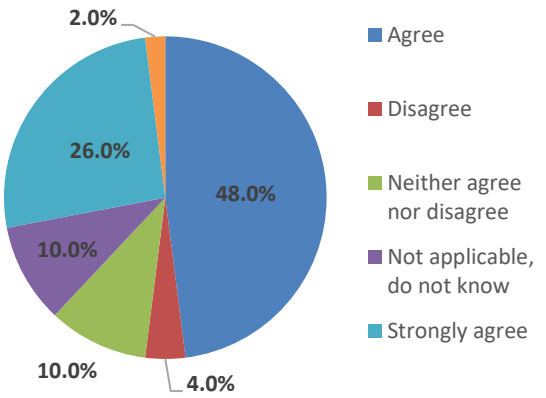
[1] 64 authorities who have been engaged in the Fund's surveillance during the last five years responded to the survey

FSAP

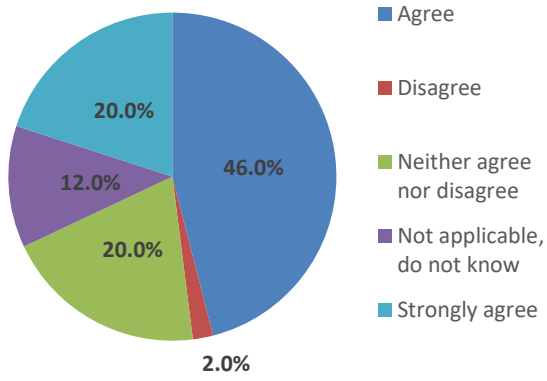
19. On FSAP, countries had positive views on the contributions made by the coverage of AML/CFT issues to the broader discussion of financial stability and soundness of the financial sector, as well as the appropriateness of the scope and depth of staff's analysis of the AML/CFT issues. The majority of the respondents agreed or strongly agreed that the coverage of AML/CFT issues in the FSAP contributed to the broader discussion of the stability and soundness of the country's financial sector (Q7). Respondents were generally of the view that the scope and depth of staff's analysis on AML/CFT issues in FSAP was appropriate given the country's ML/TF risks and the broader context of its financial sector (Q8). Respondents welcomed the Fund's targeted approach to FSAPs and the good coordination with the FATF/FSRBs assessment reports/processes. For example, respondents expressed positive views on the Fund's approach to use existing mutual evaluation reports and follow-up reports as a starting point, highlighting the progress made by the country since. Some noted a duplication of the Fund's work with the existing/ongoing work by the FATF/FSRBs, calling for greater focus on the areas where the Fund can add more value. In this context, a respondent welcomed the coverage of cross-border ML/TF risks based on financial flows analysis. Respondents also emphasized the importance of highlighting the linkages between AML/CFT issues and the broader discussion of financial stability and soundness (Q9).

Figure V.13. FSAP

The coverage of AML/CFT issues in the FSAP contributed to the broader discussion of the stability and soundness of your country's financial sector (Q7).
(in percent)[1]



The scope and depth of staff's analysis on AML/CFT issues in FSAP was appropriate given your country's ML/TF risks and the broader context of its financial sector (Q8).
(in percent)



Source: Country authorities survey.

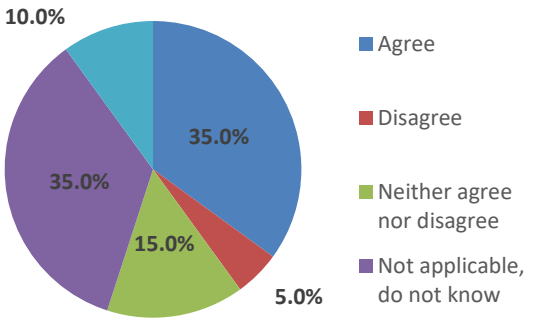
[1]50 authorities who have been engaged in FSAP during the last five years responded to the survey.

Fund-Supported Programs

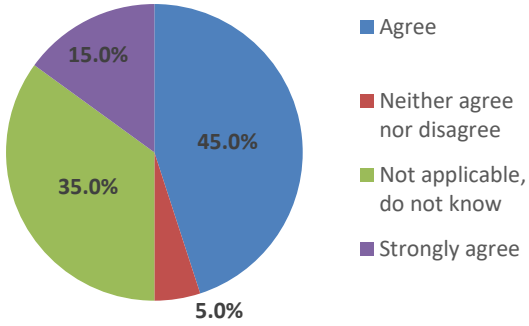
20. The respondents had overall positive reactions on the inclusion of AML/CFT-related conditionality in the Fund-supported programs. Forty-five percent of the respondents noted the inclusion of AML/CFT-related conditionality when their countries' AML/CFT weaknesses were assessed as severe or when they were critically important for achieving the program goals (excluding those who answered "not applicable," the percentage is over 60 percent) (Q10). Over half agreed or strongly agreed that such conditionalities and policy commitments were targeted, specific, actionable, and in line with the country's ML/TF risks (Q11). The majority of the respondents agreed or strongly agreed on the positive outcomes that the AML/CFT-related conditionalities brought about (Q12).

Figure V.14. Fund-Supported Programs

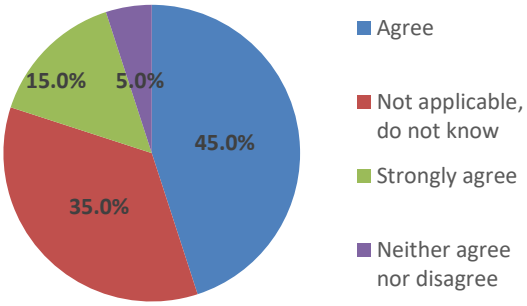
AML/CFT-related program conditionality or policy commitments were included in the Fund-supported program(s) for your country when AML/CFT weaknesses were assessed as severe or when they were critically important for achieving the goals of the program(s). (in percent)(Q10)



AML/CFT-related conditionality/policy commitments included in the program(s) were targeted, specific, actionable and in line with your country's ML/TF risks. (in percent) (Q11)



AML/CFT conditionality resulted in positive outcomes to strengthen the effectiveness of your country's AML/CFT framework and mitigate its ML/TF risks. (in percent) (Q12)



Source: Country authorities survey.

[1] 20 authorities responded to the program related questions. Given that only 15 respondents answered they participated in Fund-supported programs in an earlier question, there are non-recipients of programs among the respondents to these questions. The results, therefore, need to be interpreted with caution.

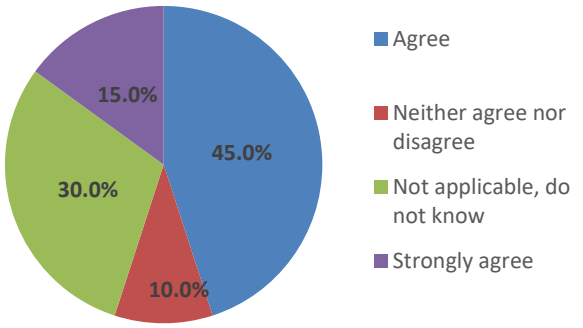
CD

21. Authorities expressed positive views on the timely and useful delivery of the Fund's CD program and its impact on the effectiveness of their AML/CFT framework and the capacity of their public officials. The majority of them found that the technical assistance delivery was timely and useful to help their country strengthen the effectiveness of the AML/CFT framework (Q13). Respondents also found that the Fund's training was timely and useful to help improve the capacity of their country's public officials in charge of AML/CFT (Q14).

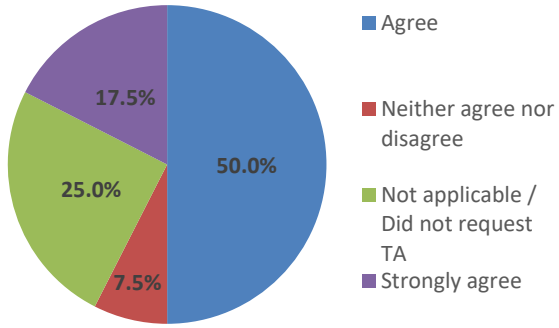
22. The majority of the respondents positively viewed the Fund's AML/CFT CD support in areas needed by the country's authorities (Q15). On modalities, over 60 percent agreed or strongly agreed that CD has been effectively delivered through in-person missions and virtual engagement (Q16). Country authorities find a wide range of the Fund publications useful, including policy papers, FSAP and surveillance reports, detailed assessment reports, books, research papers, and other publications (Q17). Authorities welcomed the Fund's regional projects (Nordic-Baltic project) and the training programs, including those on VA/VASPs and risk-based supervision, although one of the respondents suggested that the Fund's policy advice could be more specific. Feedback also highlighted the importance of the timing of CD delivery. While one of the respondents noted a postponement of delivery, there was another comment where the respondent appreciated the Fund's timely assistance, which had significant positive impact on their FATF/FSRB's assessment conducted in the same year (Q18).

Figure V.15. CD

Technical assistance delivery was timely and useful to help your country strengthen the effectiveness of the AML/CFT framework (Q13). (in percent)[1]



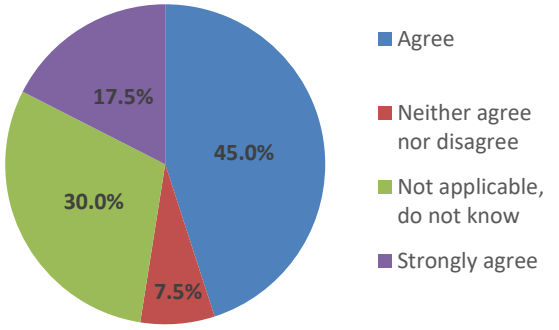
Training was timely and useful to help improve the capacity of your country's public officials in charge of AML/CFT (Q14). (in percent)



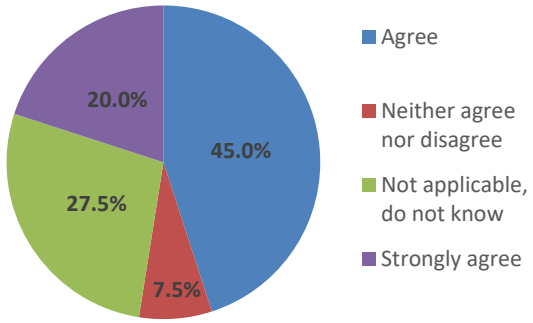
[1] Forty responses were received to the CD-related questions. Since only 39 authorities have received the IMF's CD in the last five years, at least one of the respondents is a non-recipient.

Figure V.15. CD (Concluded)

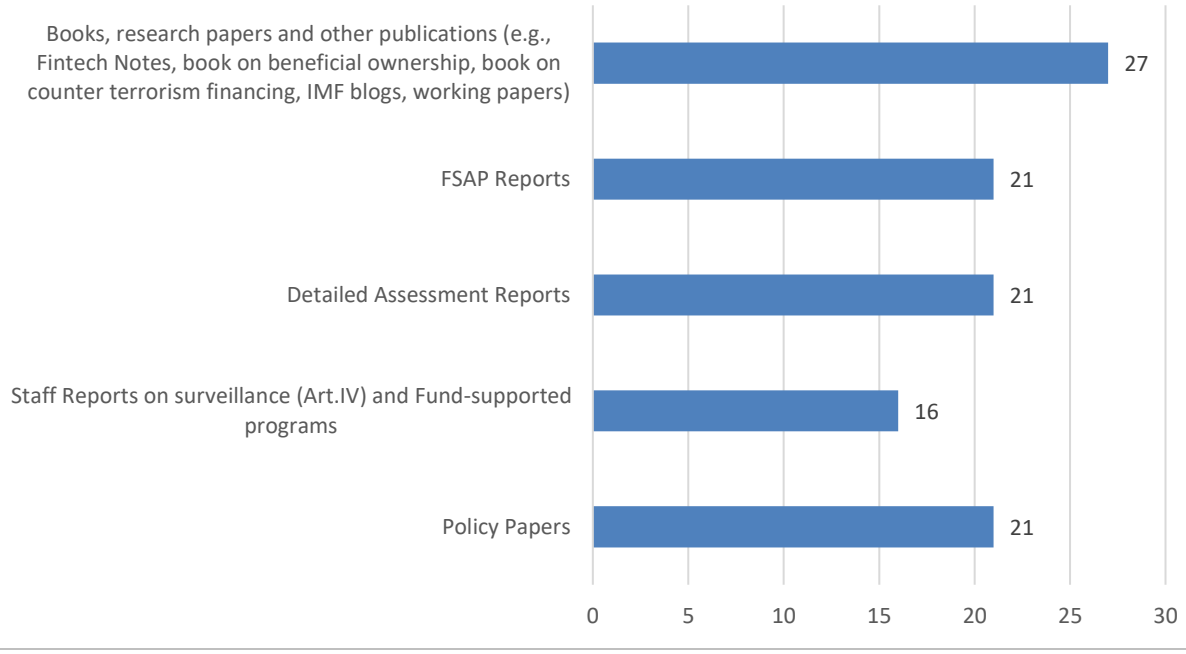
The Fund provided AML/CFT CD support where needed by your country's authorities (Q15). (in percent)



If applicable, CD has been effectively delivered through not only in-person missions but also virtual engagement (Q16). (in percent)



What Fund publications that cover AML/CFT issues are you aware of and find most useful? (Q17). (Number of responses, multiple-choice)

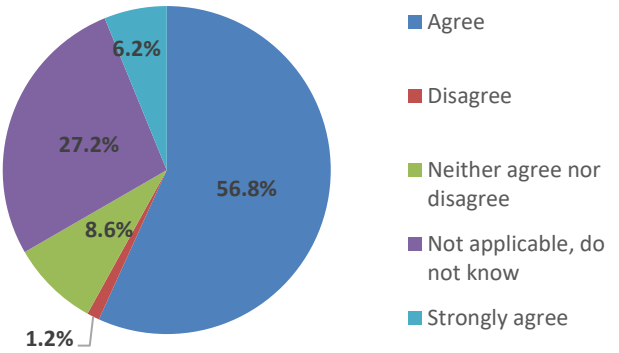


Cooperation with other International and Regional Organizations

23. Respondents consider that the Fund demonstrated good coordination with other IROs. Over 60 percent of the respondents agreed that the Fund coordinates effectively with other international and regional organizations in delivering CD and training to avoid duplication of efforts (Q19). Respondents called for greater coordination to avoid overlaps in the Fund's work and other IROs'.

Figure V.16. Cooperation with Other IROs

The Fund coordinates effectively with IROs in delivering CD and training to avoid duplication of efforts (Q19). (in percent of total sample)



Source: Country authorities survey.

Future AML/CFT Engagement

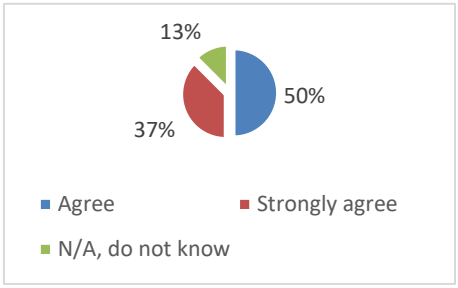
24. Respondents welcomed the Fund's significant contribution to the global AML/CFT efforts. Going forward, respondents suggested that the Fund should continue to strengthen its cooperation with FATF, FSRBs, and other IROs in providing technical assistance, including training of assessors and countries awaiting assessments. Notably, some suggested that the Fund should increase the number of the Fund-led assessments. On thematic issues, respondents suggested that the Fund should put more focus on areas such as financial flows analysis, beneficial ownership transparency, Fintech/digital money including VAs and digital banking, cybercrime, risk-based supervision, and development of data analytic tools and methodologies for risk assessment and supervision. Measures against PF, TF risks of NPOs, CBRs, asset recovery, and further research of the economic impact of FATF-listing were also highlighted as potential areas of increased focus. A respondent from an LIC noted their capacity constraints and stressed the importance of the Fund's assistance, particularly in enhancing beneficial ownership transparency.

D. Survey Responses from International and Regional Organizations

25. Staff received inputs from 24 international and regional organizations (with 100 percent return rate) engaged on AML/CFT issues as part of the external outreach exercise for the 2023 AML/CFT strategy review. Overall, IROs have found that the Fund's engagement on AML/CFT issues across different workstreams is appropriate in addressing the ML/TF and broader financial integrity risks faced by its member countries, with 87.5 percent of the respondents agreeing or strongly agreeing with the statement (Q1).

26. IROs agreed that the overall effectiveness of the Fund's AML/CFT engagement with its members is adequate. They also agree that the Fund's work has greatly contributed to elevating the link between financial integrity, financial stability, and financial inclusion to the global policy dialogue. Going forward, IROs suggested that the Fund should continue to work on enhanced coordination with IROs, strengthening effectiveness of AML/CFT frameworks and institutional capacity, with further focus on the effective implementation of FATF recommendations, including adopting and implementing beneficial ownership systems, and mitigating ML/TF/PF risks relating to VA/VASPs.

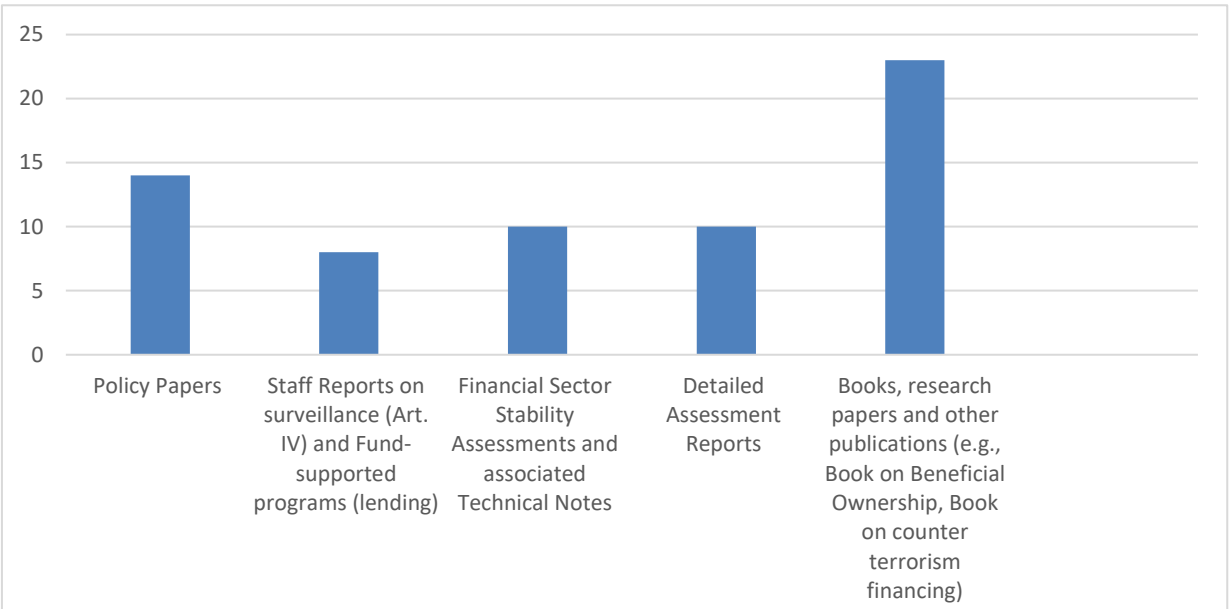
Figure V.17 Q1. The Fund's Engagement on AML/CFT Issues Including Across Different Workstreams is Appropriate in Addressing Financial Integrity Risks



Contributions to Global Policy Agenda

27. All IROs agree that the Fund has contributed to the global policy dialogue (Q3). The Fund's role in emphasizing the link between financial inclusion, financial integrity, and financial stability has greatly helped raise AML/CFT issues at the domestic policy level (Q5, Q6). IROs noted that the Fund's financial sector technical expertise and its core workstreams are important in identifying ML/TF risks that could be macro-critical. In turn, IROs have witnessed how this has increased political will in tackling ML/TF and has helped ensure AML/CFT issues receive adequate attention from finance ministries and central banks, which has stimulated additional allocation of resources (Q2, Q15). The Fund has also contributed to the global policy dialogue by providing input and feedback on various policy documents published by the FATF, FSRB, including the revision to the FATF Standards and guidance (Q3).

Figure V.18. Surveillance and Financial Sector Expertise



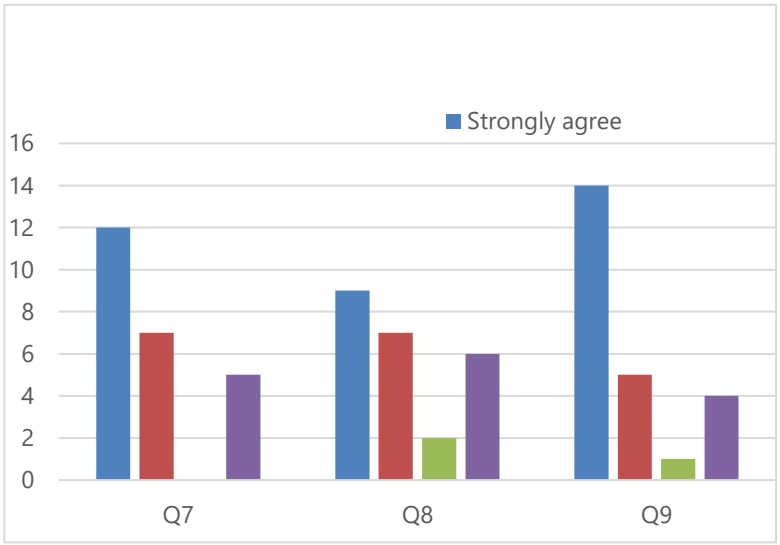
28. Going forward, respondents suggested that the Fund should continue leveraging its work on the macro-criticality of AML/CFT issues (Q5). According to several IROs, areas that could affect macroeconomic and financial stability such as VASPs will warrant discussions in AIV staff reports. Such discussions will assist competent authorities with the understanding, identification, and mitigation of these risks—especially when combined with technical assistance. Ultimately, this will lead to improved AML/CFT oversight, supervision, and access to financial services. Surveillance could also be strengthened with more AML/CFT risk and context data gathered from other areas of the Fund's workstreams. For example, the Fund work on tracking data on cross-border financial flows could also help better inform policy work by the FATF on de-risking, as well as other major policy areas.

29. While IROs appreciated the coverage of AML/CFT in core functions, several appreciated the analytical work published by the Fund with most IROs (95.8 percent) mentioning the usefulness of books, research papers and Fund publications such as Unmasking Control: A Guide to Beneficial Ownership Transparency and Countering the Financing of Terrorism: Good Practices to Enhance Effectiveness.

AML/CFT Assessments

30. IROs highlighted the quality and consistency of the Fund's work in conducting and reviewing AML/CFT assessments across the FATF Global Network (Q6, Q8, Q10). This was the most cited reason for why the Fund should continue to play an active role in conducting AML/CFT assessments in the fifth ME round (Q9, 79.2 percent agree). Most IROs agree (79.2 percent) that the Fund has contributed to conducting AML/CFT assessments and assisted other assessing bodies appropriately through reviews and other forms of support (Q7) (see Figure V.19).

Figure V.19. AML/CFT Assessments

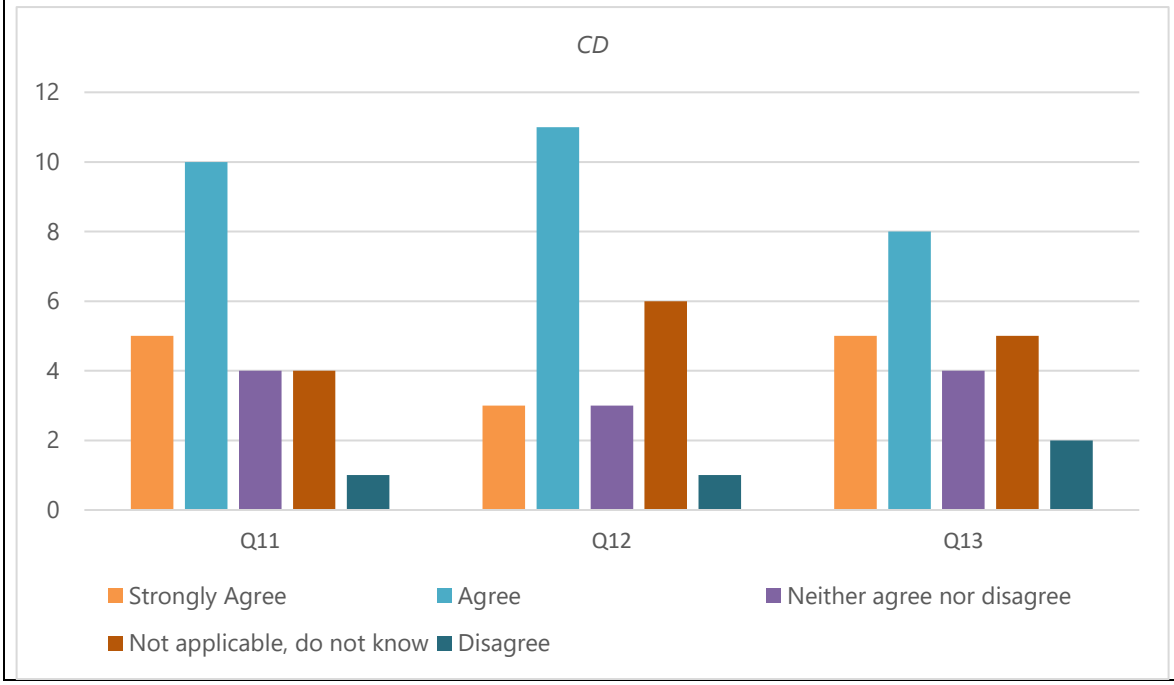


31. IROs also provided suggestions to ensure the continued quality of Fund-led assessments (Q10). These mostly relate to: (i) more involvement of the Fund and the World Bank in the ME process to ensure more quality and consistency of reports; and (ii) training to assist jurisdictions, especially country members of the FSRBs, in preparing for their ME and countries in the ICRG process.

CD

32. Respondents consider that the Fund is strong in coordinating effectively with IROs in delivering CD and training to avoid duplication of efforts (Q11, 62.5 percent agree). Most agree that the Fund offers tailored, useful, and sufficient support to IROs through its CD and training activities (Q12, 58.3 percent agree) and leverages IROs' expertise in its joint CD and training activities (Q13, 54.2 percent agree).

Figure V.20. CD



33. As general feedback, IROs stressed the importance of continued coordination (Q15). A few IROs suggested that better use of local expertise could enable competency transfer and facilitate more tailored support. When engaging with CD in specific jurisdictions, a few IROs suggested that the Fund's impact will be maximized by a detailed awareness of jurisdiction-specific financial crime issues, risks, and typologies. This also complements the call for continued focus and technical assistance on national and sectoral risk assessments by a number of IROs (Q15).

34. Thematically, CD should focus on implementing key issues under the AML/CFT frameworks. The strong work on entity transparency/ in compliance with FATF Recommendation 24 was noted and should continue. Other areas should include strengthening asset recovery, financial and tax transparency standards, Fintech/digital money (including VA/VASPs), and IFF.

Cooperation with other stakeholders

35. IROs made practical suggestions with respect to moving beyond ad hoc cooperation to facilitate strategic cooperation based on common priorities and objectives (Q6). Joint presentations and trainings, collaborative research projects, experience-sharing, and technical exchanges of experts with other IROs are a good way to reach this objective. Some IROs noted that in the last few years the Fund has been pursuing closer collaboration with IROs that have comparative advantages. In this respect, the Fund joining the Global Counter-Terrorism Coordination Compact was welcomed as a good step with respect to TF issues. This should continue while strengthening synergies in other areas. For example, considering the significant role the private sector plays on AML/CFT, a respondent suggested that the Fund should strengthen its cooperation with IROs that

work with the private sector, such as the IFC (Q2, Q5, Q15). The continued cooperation on beneficial ownership frameworks and registries will also be important for the private sector (Q15).

Future Engagement

36. IROs views complement the future direction of the Fund's AML/CFT work program, in the way it plans to continue to cooperate (e.g., cooperation with IROs in its CD delivery to avoid duplication of efforts and deeper engagement with a broader range of external stakeholders). IROs also agreed with the Fund policy priorities which also reflect the international community's policy agenda (e.g., beneficial ownership and addressing ML/TF/PF risks relating to VA/VASPs). Cross-border payments, cyber-crime and cyber-enabled fraud, environmental crime, and asset confiscation and recovery are areas likely to increase in significance (Q5).

E. Survey Results from CSOs

37. In a new approach to collect CSOs' feedback on the Fund's AML/CFT work, staff engaged in a two-phase consultation process with CSOs to seek detailed views on the implementation of the strategy and recommendations for the way forward. Phase I of the consultations consisted of an online public consultation that took place from April 11 to May 21, 2023. Phase II took place in August and consisted of a virtual follow-up meeting with CSOs. This meeting focused on sharing key inputs received through the online consultation, discussing the preliminary findings, and seeking further insights on some of the issues raised and recommendations proposed. This two-phase consultation was a new approach in the 2023 review of the Fund's AML/CFT strategy and sought to engage civil society as an important stakeholder in global AML/CFT efforts. CSOs were supportive of the two-phase consultation approach, timeliness of the consultation, publication of responses, and encouraged the Fund to replicate this model in future consultations.

38. This section offers an overview of the findings from the consultation process. It is divided into two main parts: the first one focused on the findings from the public consultation (Phase I), and the second reflects the findings from the follow-up meeting with CSOs (Phase II).

39. Below is a summary of the main take-aways from the overall consultation.

Box V.2. Key Takeaways from Public Consultation and Way Forward

Key takeaways

- CSOs had overall positive view on the implementation of the 2018 Fund's AML/CFT strategy, as well as on the suitability and evenhandedness of the Fund's direction in addressing financial integrity issues in AIV consultations and Fund-supported programs.
- CSOs had overall a positive view of the appropriateness of the Fund's CD engagements on AML/CFT and of its contribution to the global AML/CFT agenda by participating in the FATF.

Way forward

- A group of CSOs suggested that the Fund should focus on the risk of IFF that can have impacts on financial stability and the broader economy, including major financial centers where ML/TF can have spillover effects by, for example, sustaining and deepening the coverage of AML /CFT issues in AIVs and FSAPs especially for IFCs.
- A group of CSOs noted that they would like to see the Fund working towards ensuring public access to beneficial ownership information across all sectors and actively promoting cooperation between tax and AML authorities.
- Some CSOs suggested that the Fund should have more regular and close engagement with CSOs working at the national level and global level on AML reforms, including by conducting CD for CSOs and sharing more information on CD and technical assistance reports.
- One CSOs expressed that the Fund should examine the connections between financial crimes such as ML and environmental crimes and another one suggested improving the transparency of CD by sharing data, including on AML/CFT and country.

Phase I: Public Consultations

Answers Received and Type of Respondents

40. Staff prepared an online survey questionnaire to seek views from CSOs on the Fund's involvement on AML/CFT issues, including on the Fund's engagement and cooperation with CSOs and multilateral organizations. The launch of the survey was announced at a panel discussion during the Civil Society Policy Forum at the 2023 Spring Meetings.

41. A total of 19 responses[5] were received from stakeholders from all over the world, including Campaign For Human Rights and Development International, Dr. Ambedakar Iok Uthan Kendar, Human Security Collective, National College of Business Administration and Economics, Open Contracting Partnership, Tax Justice Network, The Financial Accountability and Corporate Transparency (FACT) Coalition, The Sentry, Transparency International EU, and others who wished their

[5] All the responses received can be found here: International Monetary Fund, "Review of the IMF's Anti-Money Laundering and Combating the Financing of Terrorism Strategy, Public Consultation from April 11 – May 21, 2023" (Washington, 2023).

responses to be published as anonymous. Out of the 19 responses, five of them were found to be from the private sector and were therefore not considered for this exercise.

Main Findings from Online Public Consultation

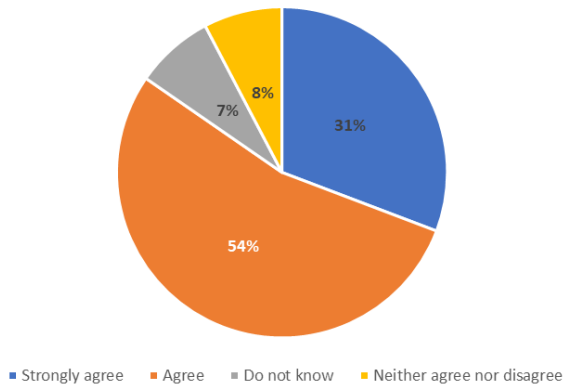
42. Following the structure of the online survey, the analysis below is divided into two main areas: The Fund's engagement on AML/CFT issues and the Fund's engagement and cooperation with CSOs and multilateral organizations on AML/CFT. It focuses on 14 valid responses received to the online consultation. For open-ended questions, we summarized responses and key observations received from CSOs. The detailed answers received can be found below.

Fund's Engagement on AML/CFT Issues

43. The respondents had positive views on the Fund's direction in addressing financial integrity issues in AIV consultations and programs. Eighty-five percent of respondents agree or strongly agree that the work of the Fund on AML/CFT is guided by the review of the Fund's strategy on AML/CFT adopted in November 2018 and the Press Release of February 2019. Additionally, nearly 70 percent of respondents agree that the direction in addressing financial integrity issues in AIV consultations and Fund-supported programs is suitable and evenhanded. However, 8 percent disagree, and 15 percent neither agree nor disagree with the statement.

Figure V.21. Q1. The Work of the Fund on AML/CFT is Guided by the Review of the Fund's Strategy on AML/CFT Adopted in November 2018 and the Press Release of February 2019 (in Percentage of Total Respondents)

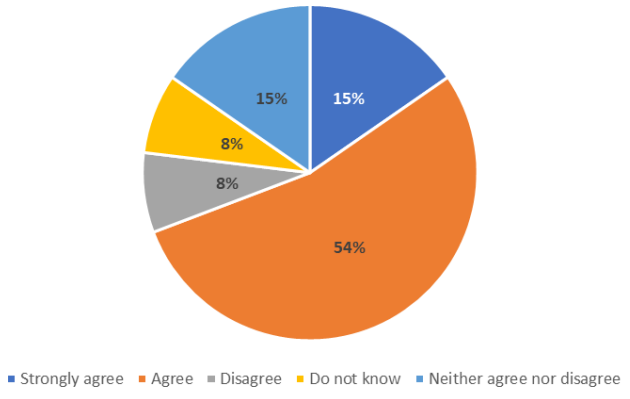
(in percentage of total respondents)



Source: CSOs public consultation.

Figure V.22. Q2. The Fund's Direction in Addressing Financial Integrity Issues in AIV Consultations and Fund-Supported Programs is Suitable and Evenhanded (in Percentage of Total Respondents)

(in percentage of total respondents)



Source: CSOs public consultation.

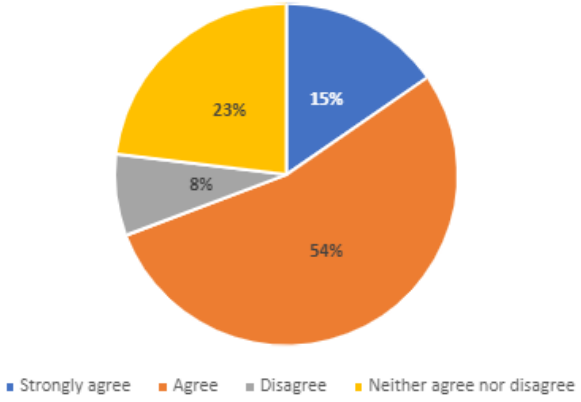
44. Tax Justice Network and Transparency International EU noted that, going forward, the Fund should sustain and deepen the coverage of AML/CFT issues in AIVs and FSAPs, especially for IFCs. The Sentry also noted that, while the Fund's assessment of the AML/CFT framework of countries in AIV reports is outstanding and in line with the FATF recommendations, there are

indications of large gaps between the analysis and implementation of the framework in some FCS, with massive systemic flaws.

45. Most respondents (69 percent) agree that the Fund positively contributes to the global AML/CFT agenda by participating in the FATF work and by assessing countries implementation of the international standards. Similarly, a majority of respondents agree or strongly agree with the appropriateness of the Fund CD engagements on AML/CFT (69 percent positive responses).

Figure V.23. Q3. The Fund Positively Contributes to the Global AML/CFT Agenda by Participating in the FATF Work on International Standards and by Assessing Countries

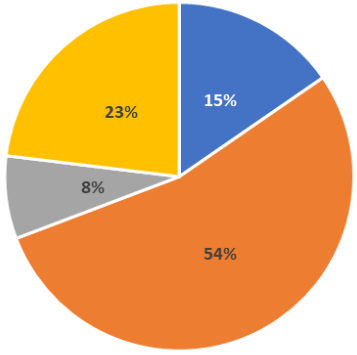
(in percentage of total respondents)



Source: CSOs public consultation.

Figure V.24. Q4. Do You Agree with the Appropriateness of the Fund CD Engagements on AML/CFT? (In Percentage of Total Respondents)

(in percentage of total respondents)



Source: CSOs public consultation.

46. CSOs identified illicit financial flows (IFF), beneficial ownership transparency, and AML/CFT-tax synergies among thematic priorities for future work. When asked for suggestions on this topic, some CSOs, such as Tax Justice Network and Transparency International EU, suggested that the Fund should focus on the risk of IFF that can have impacts on financial stability and the broader economy, including major financial centers where ML/TF can have spillover effects. These CSOs also suggested the Fund should surpass the standards set by the FATF and work towards ensuring public access to beneficial ownership information across all sectors, extending beyond COVID-19 and procurement, and including the real estate sector, as it has done in certain cases. These CSOs also encouraged the Fund to actively promote cooperation between tax and AML authorities.

47. Other CSOs suggestions asked for further focus on fiscal issues, environmental crimes, and FCS. Open Contracting Partnership, The FACT Coalition, and The Sentry asked for further focus on public financial management including public procurement, examining the connections between financial crimes such as ML with environmental crimes, and ensuring that Fund-supported programs to FCS always include AML /CFT conditionality. One CSO, Human Security Collective, called for a standardized CD module for and with NPOs.

48. Most respondents found Fund publications such as policy papers and AIV staff reports and Fund-supported programs useful. A number of respondents also noted FSAPs, Detailed Assessment Reports, research papers and other publications (e.g., Fintech/digital money Notes, Book on Beneficial Ownership, blogs) as useful sources of information.

49. When asked how the Fund can better contribute to global AML/CFT efforts to safeguard the integrity of the financial sector and the broader economy and what areas, priority activities, risks, or issues the Fund should put more focus on in the next five years, the following suggestions were shared:

- **Increase focus on cross-border ML/TF risks based on financial flows analysis, with greater attention on financial centers:** Tax Justice Network, The FACT Coalition, and Transparency International EU consider that the Fund should examine weaknesses in G7 countries and other financial centers that propagate financial secrecy and excessive data protection, facilitate sanctions circumvention, and cause spillages into other countries. Tax Justice Network and Transparency International EU also consider that the Fund should focus more on AIV reports and FSAPs that specifically address major financial centers and analyze flows that exhibit little commercial justification but could indicate acceptance of IFF (e.g., utilizing SWIFT data).

- **Promote Beneficial Ownership Transparency:** Several CSOs believe the Fund could promote the establishment and use of public beneficial ownership registries.

- **Enhance understanding on connection between financial and environmental crimes**: Examine the connections between financial crimes such as ML and environmental crimes, (i.e., as illegal mining or deforestation, especially in resource-rich countries and destination countries)

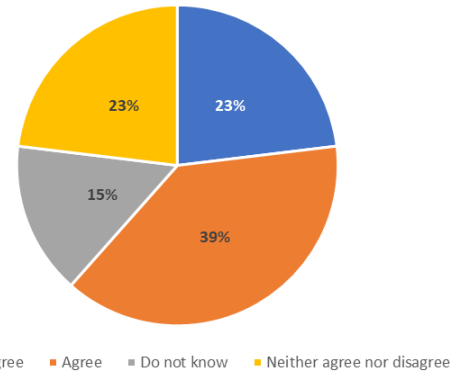
- **Strengthen the engagement with CSOs:** One CSO noted that they would like to see more regular, consistent engagement with CSOs across all countries receiving CD support to ensure their perspectives are integrated into loan governance commitments, surveillance, and assessments early on in these processes, and that these are accessible and user friendly for CSOs to use in informing their oversight and engagement with government.

- **Increase focus on the outcomes:** Publicly report not just the Fund's activities (analysis, reforms, and CD per country) on AML/CFT but also the actual outcomes of the Fund's engagement to measure the actual impact as well as publicly recognize and embrace the Fund's leading role in AML/CFT improvements to address debt distress and foster economic growth especially in FCS.

The Fund's Engagement and Cooperation with CSOs and Multilateral Organizations on AML/CFT

50. The CSOs have overall positive views on the effectiveness of the Fund's engagement with the multilateral organizations on AML/CFT issues. Sixty-two percent of the respondent strongly agreed or agreed with the effectiveness of the Fund's engagement. Going forward, two CSOs suggested that the Fund should advocate for more ambitious standards in areas such as transparency of beneficial ownership information. There was a suggestion that the Fund should assess the effectiveness of its engagement in line with its mandate to safeguard the integrity of the financial sector and broader economy, based on financial flows analysis.

Figure V.25. Q8. The Fund Has Been Effective in its Cooperation with Multilateral Organizations (e.g., FATF Network, UN, Egmont Group of FIUs) on AML/CFT Issues



Source: CSOs public consultation.

51. Coordination between the Fund and CSOs on AML/CFT. When asked what is needed to strengthen the coordination between the Fund's engagement on AML /CFT and the work of civil society, CSOs suggested (i) increasing the regularity, proactiveness and timeliness of the Fund's engagement with CSOs working at the national and global level on AML/CFT; (ii) ensuring all the country teams meet with CSOs; (iii) developing an annual civil society capacity building training with and for CSOs; and (iv) incorporating resources produced by CSOs to the Guidance Note for the Use of Third-Party Indicators in Fund Reports.

Phase II: Virtual Follow-Up Meeting

52. With the objective of sharing key inputs received during the first phase of the consultation and seeking further insights, a follow-up virtual meeting with those CSOs that participated at the first phase of the consultation was organized on August 30, 2023. Staff opened the meeting with an overview of the public consultation process and preliminary findings, followed by a discussion guided by three specific questions[6] on reactions on the consolidated version of the responses received during phase I of the consultation, additional views that they would like to share and feedback in relation to the overall preliminary proposals for the review of the strategy on AML/CFT.

53. During the meeting, CSOs shared positive reactions regarding the consolidated version of the responses received during the online survey and encouraged the Fund to replicate this

[6] Do you have views/reactions on the consolidated version of the CSOs survey responses? Today is another opportunity to provide views on the IMF Strategy on AML/CFT. Do you have additional views that we should take into account? What is your feedback in relation to the overall preliminary proposals for the Review of the Strategy on AML/CFT?

consultation process in the future. When asked if they had additional views they would like to share and feedback in relation to the overall preliminary proposals for the review of the strategy on AML/CFT, CSOs emphasized the need for the Fund to focus further on IFF issues in advanced economies and financial centers. They also encouraged the Fund to go beyond the FATF Standards, particularly on beneficial ownership transparency by requesting countries to set up public registers. Finally, CSOs cautioned that generally AML and tax are topics that are dealt with in silos and encouraged the Fund to overcome this artificial division and assist its members in building bridges across both topics.