# Financial havens, banking secrecy and money-laundering

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**The changing frontier of money-laundering**

The 10 fundamental 'laws' of money-laundering are summarised in figure 2. In essence, the rule in successful money-laundering is always to approximate, as closely as possible, legal transactions. As a result the actual devices used are themselves minor variations on methods employed routinely by legitimate businesses. In the hands of criminals, transfer-pricing between affiliates of trans-national corporations grades into phony invoicing, inter-affiliate real estate transactions become reverse-flip property deals, back-to-back loans turn into loan-back scams, hedge or insurance trading in stocks or options become matched- or cross-trading, and compensating balances develop into so-called underground banking schemes. On the surface it may be impossible to differentiate legal and illegal variants - the distinction becomes clear only once a particular criminal act has been targeted and the authorities subsequently begin to unravel the money trail.

The trend towards institutional co-mingling is enhanced by three other developments. One, which became evident first with drugs and now is increasingly apparent in other forms of illegal economic activity, is that criminal entrepreneurs have shifted from serving a set of essentially unrelated regional markets to catering to an increasingly integrated world-wide market. There appears to have been a parallel change in money-laundering. There is also some evidence to suggest that, in place of the old pattern of the occasional money-laundering institution that was usually linked directly to one or a few criminal entrepreneurs or groups, there has emerged what is virtually an integrated underground global financial system whose relations to criminal entrepreneurs employing its services tend to occur through a series of arms-length commercial transactions. Based on the (admittedly spotty) evidence surfacing in actual cases, money launderers are now more often independent contractors who are as comfortable handling drug money as washing payments for a shipment of embargo-busting arms, as skilled in assisting insider trading schemes as in moving corporate bribes.

Another aspect is that, whereas in the past the apprehension of a criminal group might well have uncovered the money-laundering apparatus along with it, now there are really two quite distinct targets of investigation and enforcement, which might require two quite separate methodologies. Pursuing trans-national crime requires better exchanges of information on particular offenders and improved facilities for trans-national investigation and prosecution of particular cases. It remains therefore fundamentally a matter of criminal law. Combating money-laundering, however, may require initiatives that might threaten not a particular institution but rather well-established systems of banking and financial practices that have a long historical pedigree and that are protected by strong vested-interest groups. It might require actions that particular jurisdictions could well interpret as a direct threat to their very sovereignty. As such, demands for action must occur in a context of full awareness of the uniqueness of the economic history and practices of each country affected.

A second complication comes from the fact that, while once it was relatively easy to separate the legal and illegal aspects of economic activity because the two existed in a different social and economic space, this is not the case today. Underground activities - either explicitly criminal or merely 'informal' - interact with legal ones at many levels. Sweatshops in big cities in the industrialised countries hire illegal aliens who are brought in by smuggling groups that may also deal in banned or restricted commodities, are financed by loan sharks who may be recycling drug money and make cartel agreements with trucking companies run by organised crime families, all in order to sell their goods cheaply to prestigious

**Figure 2. The 10 Fundamental Laws of Money-Laundering**

- The more successful a money-laundering apparatus is in imitating the patterns and behaviours of legitimate transactions, the less the likelihood of it being exposed.
- The more deeply embedded illegal activities are within the legal economy, the less their institutional and functional separation, the more difficult to detect money-laundering.
- The lower the ratio of illegal to legal financial flows through any given business institution, the more difficult will be the detection of money-laundering.
- The higher the ratio of 'services' to physical goods production in any economy, the more easily money-laundering can be conducted in that economy.
- The more the business structure of production and distribution of non-financial goods and services is dominated by small and independent firms or self-employed individuals; the more difficult the job of separating legal from illegal transactions.
- The greater the facility for using cheques, credit cards and other non-cash instruments for effecting illegal financial transactions, the more difficult is the detection of money-laundering.
- The greater the degree of financial deregulation for legitimate transactions, the more difficult will be the job of tracing and neutralising criminal money flows.
- The lower the ratio of illegally to legally earned income entering any given economy from outside, the harder the job of separating criminal from legal money.
- The greater the progress towards the financial services supermarket, the greater the degree to which all manner of financial services can be met within one integrated multi-divisional institution, the less the functional and institutional separation of financial activities, the more difficult the job of detecting money-laundering.
- The worse becomes the current contradiction between global operation and national regulation of financial markets, the more difficult the detection of money-laundering.

and eminently respectable retail outlets that serve the general public. The masses of street peddlers in the big urban centres of developing countries sell gods that might be smuggled, produced in underground factories using fake brand-name labels or stolen from legitimate enterprises, thereby violating customs, intellectual property and larceny laws. They pay no sales or income taxes but make protection payments to drug gangs that control the streets where they operate. The drug gangs might then use the protection money as operating capital to finance wholescale purchases of drugs or arms.

The result of these and many similar sorts of interfaces is an economic complex that can no longer be divided neatly into black and white; rather, it forms a continuum of differing shades of grey.

This blurring of traditional frontiers raises new problems of money-laundering control. If economic activity is no longer divisible simply into legal or illegal and if the entire economy is riddled with entrepreneurs who bend this or that rule to and sometimes beyond the breaking point, then the more accepted it becomes for people to violate 'small' laws and the greater the probability that others will decide it is permissible to break slightly larger ones, and so on up the scale.

Moreover, the greater the degree to which legal and illegal, formal and informal, underground and over ground activities are mixed, the deeper the confusion over the origins of funds, the more difficult the job of exercising due diligence with respect to crimes deemed especially serious and the greater the problems of effective use of suspicious transaction reporting.

The third development, which reinforces the problem, appears at first glance to be a minor statistical technicality but goes to the heart of modern economic development processes and impacts directly on the problem of policing criminal money flows. Although exceptions exist, economic progress is generally associated with a rise in the percentage of economic activity accounted for by the production of services as opposed to physical goods. As countries increase in wealth and degree of development, the shift in the composition of gross national product (GNP) from tangible goods to intangible services opens up new possibilities for the laundering of criminal money.

The best cover for laundering is a business engaged in legitimate retail trade, especially one that generates large amounts of cash on a regular basis. The higher the service content of the products sold, the greater the potential to use the legitimate retail business to hide the proceeds of crime. It is much easier in services to cloud the audit trail, since there is seldom as clear a relationship between physical inputs and the market value of outputs in a service firm as there is in one supplying physical goods. Tax authorities have long been aware that it is simpler in the services than in the physical goods industries to skim off income and under-report earnings. It is equally easy to do the opposite, to mix illegally earned with legally earned income and report it all as if it were legal. A simple rule is: other things being equal, the higher the ratio of services to physical goods' production in a country's GNP, the greater the facility with which its legitimate business firms can be used for laundering money.

This, in turn, has yet another implication that is potentially dangerous from the point of view of money-laundering controls. There is a widely held view that the criminal sector operates overwhelmingly with cash while the legal one uses a mixture of cash and other financial instruments. Indeed, it is common to use changes in the ratio of cash to bank instruments as a tool to estimate the size and growth rate of the underground economy. However, this simple dichotomy may be in the process of becoming obsolete. If the objective is to hide the existence of a criminal money flow or to criminalise legal income after it has been earned (by skimming and hiding) there may be few alternatives to working in cash. But if the objective is to hide the nature of a criminal money flow, an on-going alibi provided by a suitable front company, especially in the retail services field, becomes more important than anonymity. In this case there is nothing that logically precludes the use of cheques or credit cards in conducting retail deals in contraband goods and services.

Although there is a lack of data on such transactions, it would seem that while cash still dominates, the use of cheques and credit cards is rising. One of the most brilliant laundering schemes in the United States, a cocaine franchise in Boston that was dismantled in the early 1980s, worked exclusively by retail customers paying in cheques nominally on behalf of a contracting company, which deposited the money in its bank accounts to amortise a revolving line of credit that kept the supply of cocaine replenished. In some major cities today drugs can be purchased over the counter in bars if the customer gives the bartender a credit card to 'run a tab'. The value of the drugs is simply added to the total bill and settled with the credit card, and the books are balanced by the bartender, who 'skims' the appropriate amount of cash from bona fide liquor sales. Such activities can be expected to accelerate as 'smart cards' and other forms of electronic money become more popular.

The blending of legal and illegal actions and the mixing of various degrees and sorts of criminality, along with the attendant difficulty of differentiating between ordinary financial transactions and laundering and between petty and serious crime, has two important consequences with respect to anti money-laundering measures. The first is that it calls into question much of the enthusiasm about the potential use of artificial intelligence (AI) models and similar devices that are supposed to facilitate the task of sorting through great amounts of financial data. Such models can hardly anticipate all the subtle criminal variations on techniques and methods that appear to be completely innocent in themselves but that are intended to hide illegally obtained money. Artificial intelligence is no substitute for human intelligence. Indeed, it calls into question the very efficacy of imposing ever more severe general reporting requirements. It may well be that all such gross reporting requirements can offer is somewhat better reactive efficiency in following money flows once crimes have already been detected using traditional investigatory techniques, and even this will depend on the particular institutional conditions of the country concerned.

Therefore, it may be unwise to shift significant amounts of limited resource from old-fashioned and less glamorous policing methods to AI models that rely on collecting large amounts of raw information and/or depend on high-tech solutions.

The second consequence is that not only does the blurring of the frontiers between legal and illegal economic activities, along with the process by which illegal acts become institutionally embedded in legal business firms, make the tracing and unveiling of criminal money much more difficult, but it also raises the cost of doing so. The potential regulatory burden imposed on legitimate business and the degree of disruption of normal transactions flows probably increase more than proportionately. This is especially the case given the rule that the lower the percentage of illegal money running through a particular front, the more respectable that front appears and the more successful that front will be in the long term for laundering.

This implies that at some point Governments must balance the costs of further regulatory complications against the gains measured in terms of crime control. This is, to be blunt, quite messy. The costs of the extra regulatory burden are, in some cases, relatively easy to approximate in simple quantitative terms, but assessing the gains in terms of crime control is so complex and so mired in definitional and operational complications that it represents a logical and methodological swamp. Yet it is, alas, one into which everyone concerned with the issue of money-laundering will eventually be forced to step.......

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***This study was prepared on behalf of the United Nations under the auspices of the Global Programme against Money-Laundering, Office for Drug Control and Crime Prevention by Jack A Blum Esq., Professor Michael Levi, Professor R Thomas Naylor and Professor Phil Williams.***