

# Documento de Trabajo

## Working Paper

### Challenges in Strengthening the International Regime to Combat the Financing of Terrorism

*Concepción Verdugo-Yepes*

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# Challenges in Strengthening the International Regime to Combat the Financing of Terrorism (WP)

*Concepción Verdugo-Yepes<sup>1</sup>*

## Introduction

One of the top priorities of the international community during the last years, post-September 2001, has been to win the war against terrorism, and it is for this purpose that various international organisations and bodies have developed a comprehensive anti-terrorism strategy consisting of multiple components. One such component is the global effort to stop terrorist financing, which is intended to identify, disrupt and dismantle the financial networks of terrorist organisations. In this respect, what remains obvious is that at present terrorist financing has still been taking advantage of: (1) weaknesses in national regulatory schemes; (2) the informal transfer and movements of assets across national boundaries; (3) the disparity of corporate laws from one national system to another, which opens the possibility of using corporate vehicles in different States to conceal both the source and the beneficial final owner; and (4) several unregulated professional categories. For all these reasons it is of the utmost importance to look at where the failures lie in the strategy of Combating the Financing of Terrorism (CFT).

This paper's aim is to emphasise the challenges faced by international cooperation in combating the financing of terrorism. It reviews the existing weaknesses and failures of each group of stakeholders participating in the CFT strategy: (1) the lack of coordination between international organisations and the huge burden of legislations created; (2) the limitations of the institutional framework that hamper the implementation of international standards at a national level; and (3) the high ongoing costs of implementing the risk approach for private non-state actors (financial and non-financial institutions). Finally, the paper concludes by pointing out which challenges must be confronted and which actions should be taken for enhancing international cooperation.

## Weaknesses at the International Level: Lack of Coordination Between International Organisations and the huge burden of legislations created

This first section reviews the role in the fight against the financing of terrorism of the main international organisations and institutions involved in the CFT strategy: the United Nations, the Financial Action Task Force, the transgovernmental Financial Regulatory Organisations and the Egmond Group of Financial Intelligence Units.

### *The United Nations*

Terrorism is regarded by the United Nations (UN) as a pervasive and pernicious threat to global security and order, for which reason it has become one of the key international entities in addressing a wide variety of complex problems of a global character such as terrorism. The UN has the broadest range of membership as well as the ability to adopt treaties or international conventions that have the effect of law in a country once they are signed and ratified, depending on the country's constitution. The UN was the first international organisation to undertake significant action to fight money laundering (ML) on a 'truly world-wide basis',<sup>2</sup> and operates the Global Programme against Money Laundering (GPML).<sup>3</sup>

Since the mid-1980s the need for a modern anti-money-laundering strategy has become widely

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<sup>1</sup> The views expressed in this publication are the author's personal views and do not reflect the views or policies of the IMF.

<sup>2</sup> There are currently 191 member states of the UN from around the world. See List of Members, [www.un.org/overview/unmember.html](http://www.un.org/overview/unmember.html).

<sup>3</sup> See <http://www.imoling.org/imoling/gpml.html>.

accepted internationally. Progress in this area has actually become a critical tool in fighting organised crime, corruption and the financing of terrorism and in maintaining the integrity of the financial markets. The contribution of the UN to the harmonisation of actions taken against ML and FT is explored below. The first UN action was the 1988 United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (the Vienna Convention).<sup>4</sup> This Convention was the first appeal to countries to deal with provisions to fight the illicit drug trade and with related law enforcement issues. The Convention is limited to drug trafficking as a predicate offence and does not address preventive aspects. Although it does not use the phrase ML, it does define the concept, which has become the most widely accepted one. The Convention came into force on 11 November 1990.

In line with the role of the Vienna Convention, Savona (1997) and Koh (2006) state: 'The Ratification of the Vienna Convention is becoming virtually an indicator of responsible membership in the anti-drug and anti-Money Laundering world community' (Savona, 1997, p. 68). 'In the international arena, the 1988 Vienna Convention for the first time established Money Laundering as "an independent criminal offence" although it confined its application only to drug-related proceeds' (Koh, 2006, p. 43).

Before the Convention dealing with organised crime, in awareness of the global problem posed by terrorism, the UN's 1999 International Convention for the Suppression of the Financing of Terrorism<sup>5</sup> was adopted on the assumption that 'the financing of terrorism is a matter of grave concern to the international community and that the number and seriousness of acts of international terrorism depend on the financing that terrorists may obtain' (Radicati & Megliani, 2004, p. 378). The Convention requires ratifying countries to criminalise terrorism, terrorist organisations, and terrorist acts. Under the Convention, it is unlawful for any person to provide or collect funds with the intent that these funds be used, or the knowledge that the funds will be used, for terrorist activities. The Convention encourages States to implement measures that are consistent with the FATF and came into force in 2002.

The Convention<sup>6</sup> enhanced the cooperation between States in adopting effective measures while not being able to agree on a specific definition of FT. It called State parties to adopt domestic measures for the purposes of identifying, detecting, freezing or seizing funds used for (defined) terrorist offences, and to ensure that financial institutions within their territories adopted efficient measures for the identification of clients and suspicious transactions. It recommended States to prohibit the opening of accounts by unidentified holders and to ask for the licensing of all money transmission agencies.

One year later, the UN, in its strategy to undermine and disrupt organised crime groups by focusing on their finances, adopted another universal instrument, namely the 2000 International Convention Against Transnational Organized Crime (the Palermo Convention).<sup>7</sup> The approach of this convention is well illustrated in Articles 7 (1)(a) and 7 (3):

Article 7(1a) shall institute a comprehensive domestic regulatory and supervisory Regime from banks and non-bank financial institutions and, where appropriate, other bodies particularly susceptible to money-laundering, within its competence, in order to deter and detect all forms of

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<sup>4</sup> See <http://www.incb.org/e/conv/1988>, as of December 2005. See [http://www.unodc.org/unodc/treaty\\_adherence.html](http://www.unodc.org/unodc/treaty_adherence.html) and The Vienna Convention Article 3(b) and (c).

<sup>5</sup> <http://www.un.org/law/cod/finterr.htm> and UN (2006), 'Ratification, Accession, Succession or Signature of the Universal Instruments related to the Prevention and Suppression of International Terrorism, by date', UN, New York, p. 1-2.

<sup>6</sup> International Convention for the Suppression of the Financing of Terrorism, United Nations General Assembly Resolution 54/109 of 9/XII/1999.

<sup>7</sup> <http://www.undep.org/adhoc/palermo/convmain.html> and W.C. Gilmore (2004), 'Dirty Money: The Evolution of International Measures to Counter Money Laundering and the Financing of Terrorism', Council of Europe, Strasbourg.

money-laundering, which Regime shall emphasize the requirements for customer identification, record-keeping and the reporting of suspicious transactions.

Article 7 (3) then calls upon participating countries 'to use a guideline' as remarked again by Gilmore; the referred guideline is FATF standards.

The Palermo Convention came into force in September 2003, compelling ratifying countries to criminalise ML via domestic law and to consider all serious crimes as ML predicate offences, whether committed within or without the country, as well as to permit the required criminal knowledge or intent to be inferred from objective facts.<sup>8</sup> Two further criteria for application amount to the most important contribution of the UN Convention against Transnational Organised Crime. First, the offence may be committed by 'an organised criminal group' and secondly, the offence may be 'transnational in nature'.

Furthermore, the Palermo Convention establishes regulatory regimes to deter and detect all forms of ML, including customer identification, recordkeeping and reporting of suspicious transactions; authorises the cooperation and exchange of information among administrative, regulatory, law enforcement and other authorities, both domestically and internationally; considers the establishment of a financial unit to collect, analyse and disseminate information; and promote international cooperation.<sup>9</sup>

In keeping with international events, the Security Council adopted two resolutions on 15 October 1999 and 16 January 2002, respectively: SC Resolutions 1267 and 1390. These resolutions compel member States to freeze assets of individuals and entities associated with Osama Bin Ladin or members of al-Qaeda or the Taliban that are included in the consolidated list maintained and regularly updated by the UN 1267 Sanctions Committee.

Subsequently, a SC Resolution passed in response to a threat to International Peace and Security under Chapter VII of the UN.<sup>10</sup> SC Resolution 1373<sup>11</sup> was adopted on 28 September 2001 in direct response to the events of 11 September 2001. It compels countries to criminalise actions financing terrorism and to deny all forms of support for it; freeze funds or assets of persons, organisations or entities involved in terrorist acts; prohibit active or passive assistance to terrorists; and cooperate with other countries in criminal investigations and sharing information about planned terrorist acts.

Aware of the difficulties countries encounter when implementing such various legal instruments in their legislations, the UN created the Global Program Against Money Laundering (GPML). GPML is a research and assistance project offering technical expertise, training and advice to member countries on AML/CFT upon request in order to raise awareness. It helps to create legal frameworks with the support of model legislation; develop institutional capacity in particular with the creation of financial intelligence units; provide training for policymakers, judicial authorities, law enforcement bodies, regulator agencies and private financial sectors, including computer-base training; promote a regional approach to addressing problems; maintain strategic relationships and databases; and perform analyses of relevant information.<sup>12</sup>

Also, the need to harmonise national legislations, more specifically in the case of CFT, drove the UN to create the United Nations Model Terrorist Financing Bill, 2003. This model law has been developed by the United Nations Office on Drugs and Crime (UNODC) for use in countries whose

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<sup>8</sup> The Palermo Convention, article 6.

<sup>9</sup> *Id.*, 7 (1) (a).

<sup>10</sup> <http://www.un.org>.

<sup>11</sup> The hard laws in the strictest sense have been developed by the Security Council through S/RES/1267; S/RES/1373, para.1; UN, S/RES1390, para.2. These are the major standards to define hard law. However, the resolutions do not provide additional guidance for their implementation in a real situation. See Koh, 2006, p. 155.

<sup>12</sup> Report by the Chair of the Counter-Terrorism Committee on the problems encountered in the implementation of Security Council resolution 1373 (2001).

fundamental legal systems are substantially based on the common law tradition. Like any model, it will need to be adjusted to ensure both domestic legal validity (eg, in terms of constitutional principles and other basic concepts of its legal system) and domestic operational effectiveness (eg, in terms of implementing arrangements and infrastructure).

With the aim of monitoring the implementation of the resolutions and the harmonisation of international instruments within national legislations, the UN created the Counter Terrorism Committee (CTC). In a number of subsequent resolutions, the Security Council referred to best practices, codes and standards as tools that can assist States in their implementation of the resolution. In its Resolution 1377 (2001), the Council invited the Committee ‘to explore ways in which States can be assisted, and in particular to explore with international, regional and sub regional organisations... the promotion of best-practice in the areas covered by resolution 1373 (2001), including the preparation of model laws as appropriate...’. In its resolution 1456 (2003), paragraph 4 (iii), the Council requested the Committee, in monitoring the implementation of the resolution, ‘to bear in mind all international best practices, codes and standards which are relevant to the implementation of resolution 1373 (2001)’ and in its resolution 1566 (2004), paragraph 7, the Council requested the Committee ‘in consultation with relevant international, regional and sub regional organisations and the United Nations bodies to develop a set of best practices to assist States in implementing the provisions of resolution 1373 (2001) related to the financing of terrorism’.

As a result of multilateral action taken under UNSCRs 1267 and 1373, more than 170 countries have implemented blocking orders to freeze the assets of terrorists. According to the Department of Treasury, US\$147 million in assets of terrorist organisations have been blocked or frozen worldwide since 11 September 2001 (Eckert, 2008).<sup>13</sup>

After the CTC’s revitalisation in 2004, an Executive Directorate was created. The key functions of the Counter Terrorism Executive Directorate (CTED) are: to provide in-depth analysis of the implementation of resolution 1373 (2001) by States; to engage States in a dialogue through letters, direct conversations and visits on a flexible and tailored basis; and to act as a facilitator or broker of technical assistance to countries where vulnerabilities in their counter-terrorism responses have been identified. It can link this country, or a donor country or international agency that has the relevant expertise to help it overcome the problem and to keep in touch with international, regional and sub-regional organisations.

At this point, it is appropriate to outline how the actions taken by countries to meet international standards and reporting have created a huge burden, particularly for those low-income countries without the capacity and resources.

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<sup>13</sup> Further discussion on one of the cornerstones of the counter-terrorism measures such as ‘the freezing of funds to persons and entities suspected of having links with terrorism’ can be found in O’Neill (2008) and Guild (2008). Guild remarks on the way in which the listing took place and how its consequences for individuals has raised serious questions of human rights compliance. See also ‘Judgement of the Court of First Instance of the European Communities in case T-315/01 Yassin Abdullah Kadi 2005, T-306/01 Yusuf 2005 ECR II-3533, T-228/02 Organisation des Modjahedine du peuple d’ Iran 2006 and T-47/03 Sison 2007’. ‘The Court of First Instance of the European Communities, when requested to examine the legality of an implementing law, did not criticize the UN Sanctions Regime, even though it forces the EU and its Member States to blindly follow a process that most likely violates fundamental human rights like the right to a fair hearing and effective judicial review’ (Pieth, 2006, p. 1086). In accordance with Vleck (2006), the situation was complicated by the fact that there were a number of different lists of named terrorists floating around at a national and international level. The unresolved problem concerning the administrative or executive freezing provisions has led to the lack of sufficient de-freezing procedures: several rules require the creating and public announcement of de-listing and de-freezing procedures. Although the policy community’s enthusiastic embrace of financial restrictions and the apparent success to date, complications have arisen and potential problems loom with the increased reliance on such tools (Eckert, 2008).

Murthy (2007) highlights the ‘Lack of interest among poor countries (some of whom believe that terrorism is a problem of the Western Countries) is due to the absence of incentives in return for their cooperation. (...) there is a huge deficit in the desired level of cooperation and coordination between regional/sub-regional organizations and the CTC’ (Murthy, 2007, p. 8)

Ward (2003) points out that post-11 September, ‘the council sets out certain mandatory measures to prevent and suppress international terrorism, including reporting to the CTC on actions taken to implement the resolution 1373 (2001), no State met all the requirements, and it created a tremendous burden, particularly for those of a lesser degree of capacity and resources’ (Ward, 2003, p. 289). Here, it is likewise relevant to state the lack of resources and coordination between bodies and organisations in keeping with the works of several scholars.

Luck (2005) remarked that some operational areas including the Security Council as well as the CTD ‘remain understaffed and under-funded’, and that ‘the proliferation of international of international counter-terrorism efforts raises worrisome questions about coordination and coherence, even as it should quell claims that this is a simple choice between unilateralism and multilateralism, between going it alone and working with others’ (Luck, 2005, p. 25).

Similarly to Koh (2006), the researcher considers that the question of sanctions deserves great attention as a strategy to make the AML/CFT campaign effective. When a country, upon assessment, is found to be non-compliant with the AML/framework, the international community might impose sanctions on that country. The CTC has not applied its chapter VII powers to impose sanctions on States which are not compliant with the requirements of Resolution 1373. At present, CTC only reports a list of States that have been late in submitting state reports in accordance with Resolution 1373.

Regarding the impact of corruption on ML and FT issues, two more Conventions have been taken into account for the scope of this research. In response to the threat posed by corruption, the UN passed the 2003 United Nations Convention against Corruption.

This is the first legally-binding multilateral treaty to address the problems relating to corruption. On a global basis it requires parties to institute a comprehensive domestic regulatory and supervisory Regime for banks and financial institutions to deter and detect ML. The Regime must emphasise requirements for customer identification, record-keeping and suspicious transaction reporting. In accordance with article 68 (1) of the aforementioned resolution, the United Nations Convention against Corruption came into force on 14 December 2005. The Convention is also concerned with the links between corruption and forms of crime, in particular organised crime and ML. In the timeframe of this working paper, few parties have ratified this important Convention.

So far, we have revised the effectiveness of the efforts made by the UN to achieve the ratification and implementation of UN Conventions. In this working paper we state that there is a lack of resources in the countries concerned to pass legislation as well as a lack of coordination between bodies and organisations. The UN Conventions have created a huge burden, particularly for those low-income countries without the capacity and resources.

#### *The Financial Action Task Force and Mutual Evaluation*

Continuing the review of the institutions’ contribution to AML/CFT effectiveness, the second step is to evaluate The Financial Action Task Force (FATF). The role of this body relies upon what are technically ‘non-binding standards’ supported by a soft enforcement mechanism. The roots of counter-FT lie in the anti-Money Laundering initiatives adopted globally, regionally and nationally

during the 1990s. The FATF is an intergovernmental organisation established in 1989 by the G7<sup>14</sup> countries, working as a policy-making group prepared for suggesting legislative and regulatory action to counter ML.<sup>15</sup> The Forty Recommendations of the FATF constitute the international standard for effective AML/CFT measures.

The FATF regularly sees to it that its members check their compliance with these Forty Recommendations (as well as the Nine Special Recommendations on Terrorist Financing) and suggests areas for improvement through periodic mutual evaluations. The FATF identifies emerging trends and methods used to launder money and it suggests measures to combat them. An extensive analysis of the funding methods of terrorist groups and of the financial resources supporting terrorist activities has been carried out by the FATF.

The Forty Recommendations,<sup>16</sup> issued in 1990 and updated in 1996, constitute a legal framework involving patterns of ML. These recommendations include requirements for States to criminalise ML activities, to adopt customer identification and record-keeping practices and to commit themselves to cooperating with other States and IOs in AML activities. This case of ‘soft law’ responds to the logic of informal commitments, which States can spontaneously comply with. In this case, the efforts undertaken by the FAFT constitute the general and main reference for international and domestic legislation.

The 2001 FAFT review identified a problem: ML is actively investigated and prosecuted in a limited number of countries, while elsewhere the offence is not frequently prosecuted. The UN General Assembly Resolution 51/210 of 17 December 1996 recognised the specific nature of FT, not only where it is linked to drug dealing, arms trafficking and other criminal methods, but also to legal and non-criminal institutions.

At an extraordinary plenary meeting on the FT held in Washington (2001), the FAFT<sup>17</sup> decided to expand the function of the FAFT beyond ML. Eight Special Recommendations were appended to the existing Forty Recommendations. Thus, the list of potential legal sources of finance was expanded to include the collection of membership dues and/or subscriptions, sales of publications, speaking tours, cultural and social events, and examples of legitimate businesses supporting terrorism, including publishing, food production, building construction and computers.

The UN and FATF Recommendations set the root and direction for national efforts aimed at reducing the vulnerability of domestic financial systems to terrorist manipulation. AML legislation was finally especially extended to deal with FT. There should be little difficulty in expanding the scope of domestic and international AML measures and other measures and legislation to cover the funding and ML activities of terrorist networks. But the key factors lie in ‘legitimate sources’, state financial sponsorship, donations and contributions from supporters, which complicates the puzzle.

The lack of regulation of the financial system –offering attractive opportunities for terrorists to achieve their criminal goals, enabling a profitable management of financial resources as well as their transfer through informal banking channels– adds complexity to the situation. For this reason, the CFT strategy turns out to be more than a matter of combating an ordinary financial crime because of the involvement in the FT of legitimate entities and legitimate financial resources, trade,

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<sup>14</sup> The G-7 countries are Canada, France, Germany, Italy, Japan, the UK and the US.

<sup>15</sup> <http://www.fatf-gafi.org/>. Membership of the FAFT includes 29 countries plus two regional organisations (EC and Gulf Cooperation Council), representing all the main financial centres in North America, Europe, Asia and the Middle East, who band together for the purposes of investigating means to combat money laundering in all its forms. The FAFT coordinates global anti-money laundering activities working together with a variety of regional and international organizations.

<sup>16</sup> Forty Recommendations, [http://www.fatf-gafi.org/pdf/40Recs-2003\\_en.pdf](http://www.fatf-gafi.org/pdf/40Recs-2003_en.pdf).

<sup>17</sup> See FATF-GAFI, 2001a, p. 16-19.

humanitarian aid, etc, which use small amounts of money and the banking networks to elude the existing monitoring and controlling schemes.

In the conclusion to the 1990 FATF report, it was admitted that ‘a regular assessment of progress realized in enforcing Money Laundering measures would stimulate countries to give these issues a high priority’ (Levi, 2002b, p. 96). FATF II decided to supplement a process of self-assessment with a system of mutual evaluation, examined by selected other members of the FATF, according to an agreed protocol for examination and agreed selection criteria. Since the initial round of mutual evaluation, its major purpose has been to assess the degree of formal compliance with the Recommendations.

Levi and Gilmore have underlined the international significance of the FATF precedent of the rise of mutual evaluation processes:

‘That to submit to periodic on- site inspection by one’s peers, constituted a radical departure from the orthodoxy of international affairs, where considerations of autonomy and sensitivities about territorial sovereignty have traditionally dominated governmental thinking’ (Levi, 2002b, p. 108).

They believed the FATF Recommendations are a form of ‘soft law’ and these Recommendations do not formally entail a matter of international law. Some Recommendations may have been implemented into customary international law but many are regarded as lacking in any mandatory legal effect.

In line with the idea of the use of mutual evaluation reports to evaluate the compliance with the FATF Recommendations by countries/jurisdictions, Savona (1997) points out that one of the most delicate problems of the AML regulation and its control is that the enactment of legislation and issuance of regulations are obvious important steps, but their implementation is more important and more difficult to assess objectively. Official data on implementation, such as that provided though the mutual evaluation reports<sup>18</sup> of the FATF, are essential for him. He also referred in his work to the difficulties in analysing cross-laundering data from different countries because every country will display peculiarities in criminal behaviours, policies, implementation, recording and reporting, which makes any kind of meaningful aggregation difficult.

On the premise that the mutual evaluation report is the best tool for evaluating the implementation of FATF Recommendations by countries, we will extrapolate the results of 46 jurisdictions’ mutual evaluations in order to determine the global level of compliance.<sup>19</sup> This captures the fact that countries/jurisdictions may well comply with some Recommendation while not complying with others.

To date, response policies towards non-compliance have been active to the extent of threatening to suspend FATF membership of some countries until the Recommendations have been implemented. The issue of non-compliance policy merits greater examination by this researcher in the sense of ‘establishing the minimum compliance’ that should be achieved among FATF members because at present the Recommendations allow a considerable discretion in their application.

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<sup>18</sup> The present author, when researching how to obtain the information about mutual evaluation reports, takes into account the recommendations given by IO officials. An UNODC official suggested looking through the websites of regional FATF-style bodies: ‘there you will find reports and evaluation results of FIU and AMF/CFT regimes’. Also, a FATF official answered to the questionnaire that ‘to find the statistics that you are looking for, I would suggest that you consult the FATF mutual evaluation reports for FATF member countries that are published on our website at [www.fatf-gafi.org](http://www.fatf-gafi.org)’. Furthermore, a Moneyval Official recommended the author ‘to visit the FATF website [www.fatf-gafi.org](http://www.fatf-gafi.org), which contains many interesting documents, including evaluation reports, which might be useful for your research’. Furthermore, a Reserve Federal Bank official recommended the author to try the IMF/World Bank AML assessments for various countries. FATF started a third round of mutual evaluations for its members in January 2005.

<sup>19</sup> Definitions of compliance, primary rule system, a compliance information system and a non-compliance response system can be found in Mitchell (2006, p. 141-143).



With regard to response policies toward non-member countries, the FATF applies the same measures as with member countries. Nonetheless, the FATF can recommend broader countermeasures.<sup>20</sup> With the aim of evaluating non-FATF members, the Non-Cooperative Countries and Territories (NCCTs) exercise began in 1998 when the majority of the countries did not have AML measures in place. The intent of this initiative is to secure the adoption by all financial centres of international standards to prevent, detect and punish ML, and to reach effective international cooperation in the global fight against ML/FT.

‘In February 2000, the FATF published the initial report on NCCTs, which included 25 criteria identifying detrimental rules and practices that impede international co-operation in the fight against Money Laundering. The exercise reviewed 47 jurisdictions in two rounds of reviews (31 in 2000) and (16 in 2001). A total of 23 jurisdictions were identified as NCCTs (15 in 2000<sup>21</sup> and 8 in 2001).<sup>22</sup> No additional jurisdictions have been reviewed under this process since 2001’ (FATF-GAFI, 2006).

In the last year, the FATF agreed to the removal of Nauru and Nigeria from the NCCT list. The FATF is also ending a formal monitoring of countries de-listed prior to June 2005. The future monitoring of these countries will be conducted within the context of the relevant FSRBs and their evaluation mechanisms. Some of the countries within the sample have been pressured because of their being unregulated jurisdictions and have been included in the NCCT list in 2000-01, which includes countries such as Panama and Hungary. In this dissertation, we shall pay special attention to the evolution of the AML/CFT implementation in these countries. As of writing, only Myanmar is still considered by the FATF to be an NCCT.

In the light of the results of NCCT<sup>23</sup> evaluation, non-compliance response policies should be implemented in accordance with FATF,<sup>24</sup> consisting of measures such as: actions to put an end to the detrimental rules and practices; counter-measures designed to protect economies against money of unlawful origin; specific requirements for financial institutions in FATF members to pay special attention to, or report on, financial transactions conducted with individuals or legal entities having their account at financial institutions established in a ‘non-cooperative jurisdiction’; and conditioning, restricting, targeting or even prohibiting financial transactions with non-cooperative jurisdictions. There have been, to my mind, two failures of the NCCT exercise. First, the NCCT criteria application does not contain references to combating the financing of terrorism requirements, ‘if NCCT criteria included these [CFT] elements in the future, a link could be secured to the binding resolutions of the Security Council (...). Security Council Resolution 1373 imposes binding obligations on all States to suppress the financing of terrorism and in this sense, there could be further justification for the NCCT initiative under the authority of Security Council’ (Koh, 2006, p. 166).

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<sup>20</sup> For further discussion on these countermeasures that ‘should be gradual, proportionate and flexible regarding their means and taken in concerted action towards a common objective’ see FAFT (2002, p. 6) as well as cited in Koh (2006, p. 164).

<sup>21</sup> Antigua and Barbuda, Belize, Bermuda, British Virgin Islands, Cyprus, Gibraltar, Guernsey, Isle of Man, Jersey, Malta, Mauritius, Monaco, Samoa, Seychelles, St Lucia, Vanuatu, *Bahamas, Cayman Islands, Cook Islands, Dominica, Israel, Lebanon, Liechtenstein, Marshall Islands, Nauru, Niue, Panama, Philippines, Russia, St. Kitts & Nevis, St Vincent & the Grenadines* (the 15 jurisdictions identified as NCCTs at that time are in italics).

<sup>22</sup> Costa Rica, Czech Republic, Palau, Poland, Slovakia, Turks & Caicos Islands, United Arab Emirates, Uruguay, *Egypt, Grenada, Guatemala, Hungary, Indonesia, Myanmar, Nigeria and Ukraine* (the eight Jurisdictions identified as NCCTs at that time are in italics).

<sup>23</sup> Discussion on the controversy of a non-universal body seeks to enforce non-binding standards on non-member countries (NCCT); see Koh (2006); Mitsilegas (2003); and Johnson *et al.* (2002). It has been seen that FATF member countries consider the domestic policies and legal systems of the identified NCCTs to be undermining their legitimate national interests. In other words, the FATF members imposed a ‘standardisation’ (eg, in October 2007, the FAFT was concerned that the Islamic Republic of Iran’s lack of a comprehensive (AML/CFT) regime represented a significant vulnerability within the international financial system. The FATF called upon Iran to address its AML/CFT deficiencies on an urgent basis. The FAFT members advised their financial institutions to take the risk arising from the deficiencies in Iran’s AML/CFT regime into account for enhanced due diligence.

<sup>24</sup> For further detail on counter-measures see FATF (2000, p. 7-9).

Secondly, the FATF members have imposed a harmonisation of its standards to non-FATF members. When applying its Recommendations<sup>25</sup> for AML/CFT compliance, it has been rare for the FATF to inform the CTC of this fact. The present researcher agrees with Koh that this lack of initiative to list a ‘non-compliant state twice’ by FATF and CTC has decreased the effectiveness of AML/CFT strategy world-wide.

#### *Transgovernmental Financial Regulatory Organisations*

Prior to closing the section that evaluates the role of IOs and bodies in the consecution of AML/CFT effectiveness, we must also take into account the transgovernmental regulatory organisations, which have played a leading role in the AML/CFT strategy. Recent work on transnational politics suggests that international organizations as transnational governmental networks (Slaughter, 2004) and epistemic communities (Haas, 1992) may have a strong impact on areas previously thought to lie within the domain of domestic governance.

For this reason, we will pay attention to issues that constrain the transgovernmental regulatory organisation for protecting the integrity of the financial system. We shall review such regulatory organisations as the Basel Committee, IAIS and IOSCO. It should be noted at this point that the regulation relies on its members to implement its Recommendations within their respective countries.

Reports on overall compliance with integrity standards found that regulators had a lack of authority to investigate, limited access to time-sensitive data needed for surveillance purposes, insufficient resources for inspection, surveillance and investigation, and often a limited enforcement mandate. The reports also underline that there is a clear need for more efficient methods to disseminate information to the public and to improve the quality of the information being released.

Reports conclude that weaknesses in the implementation of many of the BCP, IAIS and IOSCO principles were evident across a range of jurisdictions, although the most marked concerns were those related to assessments of developing and emerging markets. The implementation of these rules applicable to financial systems greatly differs among countries within the same region. For this reason, one should point out the necessity to supplement and emphasise effective regional ‘surveillance’ mechanisms for the improvement of all integrity standards.

The Basel Committee on Banking Supervision (Basel Committee) was formed in 1974 by the central bank governors of the Group of 10 Countries.<sup>26</sup> It has issued three documents covering ML

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<sup>25</sup> In accordance with FATF’s Recommendation 21, financial institutions should give special attention to business relationships and transactions with persons, including companies and financial institutions, from countries which do not or insufficiently apply the FATF Recommendations. Whenever these transactions have no apparent economic or visible lawful purpose, their background and purpose should, as far as possible, be examined, the findings established in writing, and be available to help competent authorities. Where such a country continues not to apply or insufficiently applies the FATF Recommendations, countries should be able to apply appropriate countermeasures. In accordance with Recommendation 21, the FATF recommends that financial institutions give special attention to business relations and transactions with persons, including companies and financial institutions, from the ‘non-cooperative countries and territories’ and in so doing take into account issues raised in relevant summaries of the annual NCCT reports and any progress made by these jurisdictions since being listed as NCCTs. The FATF itself does not determine what specific measures financial institutions must take. It is up to each country to issue its own specific guidance or regulations with which financial institutions must comply.

<sup>26</sup> <http://www.bis.org/index.htm>. The group of 10 countries is a misnomer, since there are 13 member countries. The Basel committee members (as well as the Group of 10) are: Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, The Netherlands, Spain, Sweden, Switzerland, the UK and the US. Also, a private initiative, the Wolfsberg Group, has developed a Guide on a Risk-Based Approach for Managing Money Laundering Risks to support risk management and assist institutions in exercising business judgement with respect to their clients. The Wolfsberg Group consists of the following leading international financial institutions: ABN AMRO, Banco Santander, Bank of Tokyo-Mitsubishi-UFJ, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan Chase, Société

issues:

- (1) Statement on Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering. It contains 4 principles that should be used by banking institutions: (a) proper customer identification; (b) high ethical standards and compliance with laws and regulations; (c) cooperation with law enforcement authorities; and (d) policies and procedures to be used to adhere to.
- (2) The 25 core principles for effective banking supervision, stipulating that bank supervision must determine that they have adequate policies and procedures in place, including strict know-your-customer (KYC) rules. Core principle 15 is linked to AML policies put in place.
- (3) A paper called ‘customer due diligence for banks’: this paper provides extensive guidance on an appropriate CDD policy.

Recent assessments<sup>27</sup> of compliance with these regulatory standards found that 45% of the evaluated countries (36) have inadequate or no legal framework to comply with the Core Principle 15. The report states the following:

‘Preconditions for effective banking supervision are generally in place in advanced economies. In developing countries, a number of shortcomings in the underpinning infrastructure were observed: transparency is rather low, at times due to opaque financial statements and problems in accounting and auditing. However, many emerging markets that have recently experienced the transition to market economies face substantial challenges in making their accounting systems consistent with international practices, and the need to test and properly implement recent changes in their legal system’ (IMF, 2004, p. 13).

The use of insurance for the scope of ML has been discussed in previous chapters of this dissertation. The international Association of Insurance Supervisors (IAIS), established in 1994, represents the insurance supervisory authorities from 130 jurisdictions. The role of the IAIS is to promote cooperation among insurance regulators; to set international standards for insurance supervision; to provide training to members; and to coordinate work with regulators in the other financial sectors and international financial institutions.

In January 2002, the association issued the Guidance Paper No.5, Anti-Money Laundering Guidance Notes for Insurance Supervisors. This AML Guidance note should be implemented by jurisdictions taking into account the particular kind of insurance business offered within and the characteristics of its financial and legal system.

Recent assessments of the IAIS core principles on insurance supervision on 42 countries concluded: ‘that there is unclear jurisdiction of the insurance supervisory bodies over corporate governance issues, and the system depends on general corporate laws and regulations’. The report also shows that the ‘absence and deficiencies in the exchange of information with other supervisors’ (IMF, 2004, p. 31).

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Générale, and UBS. See

[http://www.baselgovernance.org/fileadmin/docs/pdfs/Industry\\_standards/Wolfsberg\\_RBA\\_paper.pdf](http://www.baselgovernance.org/fileadmin/docs/pdfs/Industry_standards/Wolfsberg_RBA_paper.pdf).

<sup>27</sup> The FSAP assessments and key cross sector structural and regulatory risk factors in 36 countries show that: in Africa regulators and regulated at less than arm’s length distance and regulatory resources are inadequate, consolidated supervision is not in place, and regulatory cooperation is ill-defined; in Asia regulation is still on single lines of activity; in Europe the financial systems are strongly exposed to internationalization of capital flows; in the Middle East and Central Asia there is no instance of a unified regulator and there is a prevalence of Islamic financial principles; and in the Western Hemisphere there is a problem of disclosure and related party and intra-group transactions.

The International Organization of Securities Commissioners (IOSCO) passed a 'Resolution on Money Laundering' in 1992. The resolution provides that each IOSCO member should consider customer identifying information record-keeping requirements; ensure monitoring and compliance procedures designed to deter and detect ML and have appropriate powers to share information in order to combat ML.

Recent assessments of the IOSCO principles implementation show that most assessors found that regulators had a lack of authority to investigate, had limited access to time-sensitive data needed for surveillance purposes, insufficient resources for inspection, surveillance and investigation, and often a limited enforcement mandate. With respect to issuers, there is a clear need for more efficient methods to disseminate information to the public and to improve the quality of the information being released. There is also a need to address the lack of harmonisation between international and domestic accounting and auditing standards.

#### *The Egmond Group of Financial Intelligence Units*

We may close this section with the review of the Egmond Group's contribution to AML/CFT effectiveness. A few Financial Intelligence Units (FIUs)<sup>28</sup> were created in 1990 in response to the lack of a central agency to receive, analyse and report the heterogeneous information needed to combat terrorism. In 2003 the FATF included explicit Recommendations on the establishment and functioning of FIUs. Over the last years the IMF and WB have recognised the importance of an FIU in the AML/CFT strategy and they have provided technical assistance to countries in the establishment and strengthening of FIUs.

The existence of an FIU is justified due to the criminal behaviour of money launderers and terrorists, which is compared by contributors in a World Bank report to a 'stream of water, following gravity and constantly prodding the banks for weak points through which it can spread further'. And this behaviour is the main challenge currently faced by FIUs:

'FIUs currently face more specific challenges. The most important ones are the integration of the financing of terrorism in their work, the broadening of the suspicious transaction reporting obligation beyond the regulated financial sector, and the quest for improved international cooperation' (WB, 2004, p. 92).

Traditional FIUs have been used to deal with ML, but the strategy to fight against terrorism is different and it will force FIUs to integrate new functions (above all the rest) in those countries that have never faced terrorism.

The extension of the reporting in the case of the designated non-financial businesses and professions (DNFBPs): casinos (which also includes internet casinos), real estate agents, dealers in precious metals, dealers in precious stones, the accounting and legal profession have had and will continue to have a wide implication for FIUs. My prediction on this matter is that the FIUs will have to devote specialised resources to supervise the new types of reports coming from DNFBPs. Against this background, it seems clear that the existence of an effective national FIU unit may help the effectiveness of the AML/CFT.

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<sup>28</sup> For a broad explanation of the Financial Intelligences Units, see WB (2004), 'Financial Intelligence Units: An Overview', International Monetary Fund, p. 149. See also <http://www.egmontgroup.org/> and see [http://www.egmontgroup.org/statement\\_of\\_purpose.pdf](http://www.egmontgroup.org/statement_of_purpose.pdf). For a list of FIUs see [http://www.egmontgroup.org/list\\_of\\_fius\\_062304.pdf](http://www.egmontgroup.org/list_of_fius_062304.pdf).

## State Actors: Institutional Factors Limiting the Implementation of AML/CFT International Standards

As was our goal when measuring<sup>29</sup> the compliance of 46 countries with the AML/CFT (see Annex I), we have gained an understanding of the weaknesses and failures of the implementation of the AML/CFT standards which are presented as follows. In accordance with the results of jurisdictions' compliance with the AML/CFT recommendations displayed in the annex, we shall now highlight the most important weaknesses of AML/CFT compliance, which not only correspond to the limitations of the countries/jurisdictions when it comes to developing domestic regimes, but also to the fact that the governments of these countries have not found support for their policies to tackle ML/FT from the regime participants.

It is here that we may usefully explain the underlying weaknesses in worldwide compliance. These weaknesses may be categorised into four: (1) failure to ratify and implement international conventions on ML and FT in some countries; (2) inadequate customer identification policies in countries within all income groups; (3) countries fail to provide resources to supervise AML programmes and institutions; and (4) countries fail to enhance mutual legal assistance, information sharing and cooperation with national sectors and those across borders.

### *Failure to Ratify and Implement International Conventions on ML and FT in Some Countries*

The international legislative Regime against terrorism is characterised by diversity and fragmentation in the way it shows the ratifications of the international Convention on Terrorism. Despite the existing anti-terrorist Conventions before 2001, they are not universal. Technical standards developed for fighting against ML and FT have not been adopted by a great number of States. International anti-terrorism laws only exist on paper in many countries. The most important weakness for the AML/CFT lies in the inability of the international community to find a definition of terrorism, something that has constrained the system, and this situation permits the existence of havens for terrorist networks.

Furthermore, when analysing the mutual evaluation assessments, one realises that the names of terrorist groups are different depending on who has compiled them: the UN, the EU, the US or the UK. There are no international agreements as to what constitutes terrorism and FT (eg, the IRA is a terrorist group for the UK, but not for the US; Hezbollah is a terrorist group for the US but not for the EU).

In some countries, the list of predicate offences does not respect the 40 Recommendations. There is only a limited number of predicate crimes for ML and it means that incrimination of ML is not fully consistent with the Vienna and Palermo Conventions. When ML is prevalent in a country, it generates more crime and corruption, and the effects of countries' attractiveness for ML purposes have been broadly discussed by Unger (2006).

There is also an inadequate, weak and selective enforcement of AML/CFT provisions. The confiscation Regime is not clear and effective enough. Ineffective penalties, including difficult confiscation provisions are some of the reasons why the freeze strategy has not been more successful. The lack of ML prosecutions within the sample indicates that the Regime is not being effectively implemented. In the majority of countries, no sanction Regime exists for ML offences committed by natural persons acting as a front or on behalf of a trustee.

In addition, the lack of harmonisation of corporate law worldwide can create a 'domino effect' on other laws and regulations, such as the criminal, administrative and banking laws. The greatest

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<sup>29</sup> The methodology to evaluate 46 jurisdictions' compliance and detailed results of the analysis of compliance by 46 jurisdictions with the FATF recommendations can be found in Verdugo (2008a) and Verdugo (2008b).

obstacles to international cooperation for the prevention of ML are still found in the area of ‘identification of the real beneficial owner’. The main obstacle is a lack of regulation requiring full information regarding the real beneficial owner of a public or private limited company, especially when a legal entity is a shareholder or director, or the issuance of bearer shares is permitted.

#### *Inadequate Customer Identification Policies in Countries within All Income Groups*

The low level of overall compliance in this area is due to the fact that the customer due diligence approach to fighting ML and FT is not a simple task and can contradict the culture of banking which is that of gaining clients. The compliance officer or risk manager in charge of ‘customer due diligence (CDD)’ tends to be in conflict with the incentives provided to customer service units dedicated to personal, private or offshore banking. In addition, national corporate law can affect the opacity/transparency of the financial system. Predominantly, the preventive measures have only been taken in formal economies.

In relation to these results, it is convenient to revise a couple of issues related to preventive measures. In some countries, it has not been clearly shown that bank secrecy has been fully lifted by the AML national law. This research points out that some countries and jurisdictions put the financial system at risk while maintaining their secrecy laws.

For example, in relation to Recommendation 5 Customer due diligence (CDD), 86% of the countries are not totally compliant with the core goal of the AML/CFT Regime, that is, to undertake customer due diligence measures, including identifying and verifying the identity of their customers when establishing business relations, carrying out occasional transactions, and when there is a suspicion of ML or FT and the financial institution has doubts about the veracity or adequacy of previously obtained customer identifications.

Regarding the compliance with 9 Special Recommendations against the financing of terrorism, most countries deal ineffectively with the Special Recommendations related to preventive issues such as: the wire transfers still not being adequately recorded, the non-profit sector requiring greater control, greater effort being needed for detecting couriers and a similar need also extending to the use of bearer instruments.

#### *Countries Fail to Provide Resources to Supervise AML Programmes and Institutions*

The absence of a strong political commitment at the level of policy makers and legislators is a significant hindrance to the development and implementation of a robust AML/CFT framework as well as the high start-up and ongoing costs challenge the implementation of the AML/CFT Regime. Law Enforcement officers also need more police, customs agents need to stop smuggling, financial regulators need to strengthen their regulations and politicians need to be aware of their respective countries’ risk of terrorism and money laundering and to provide a reasonable degree of security for the citizens before whom they are ultimately responsible. In the long run, investment on these resources is likely to pave the way for the fight against ML/FT.

#### *Countries Fail to Enhance Mutual Legal Assistance, Information Sharing and Cooperation with National Sectors and those Across Borders*

The authorities’ power for cooperation is affected by the absence of clear rules. The lack of clear rules in ‘mutual legal assistance’ renders the process of international cooperation and the sharing of information less systematic. Some weaknesses must be overcome in order to enhance international cooperation. It is necessary to find gateways for sharing information while protecting legitimate rights to privacy and taking account of supervisors’ confidentiality obligations; sharing information among supervisors of different sectors (eg, between banking, securities and insurance regulators); sharing information for regulatory, compliance, and law-enforcement purposes; solving the complexity of multiple gateways for information exchange; and harmonising laws and overcoming obstacles that arise in areas of extradition, mutual legal assistance and corporate law that can undermine the fight against terrorism.

From the results we have obtained it is patent that there are differences in attitudes and in agendas between different countries when it comes to dealing with the same problem. ‘Problem recognition, generation of policy proposals, and political events’ (Kingdon, 1995, p. 18), in this respect, is a key question prior to implementing the CFT strategy.

According to the World Bank and the IMF, countries are facing the following challenges in implementing the recommended reforms: The first challenge for AML/CFT international harmonisation is to achieve sufficient political commitment. At the first stage, there is an absence of strong political commitment at the level of policy makers and legislators, which is a significant hindrance to the development and implementation of a robust AML/CFT framework. In some countries, the dedication of officials at the technical level of supervisory and law enforcement authorities is hampered by a lack of political commitment on the part of both government and parliament to pass legislation and assign the necessary resources. The first step for a strong political commitment lies in the ratification of the International Convention related to terrorism and ML.

It is also important to underline that a political agenda is always evolving in time, especially in the case of FT and ML. In this respect, it would also be interesting to understand not only how certain topics came to be considered relevant, but also which factors lead to change within political agendas. The difficulties in the implementation of AML/CFT strategy lie in achieving a uniform perception of a global problem such as ML/FT as a priority issue in agendas the world over. Without this uniformity it is very difficult to achieve a convergence on the harmonisation of international standards.

In addition to this agenda problem, there are others issues which explain the failure to implement the international recommendations, such as corruption and weak governance<sup>30</sup>. In environments where corruption is prevalent, legislators are less likely to enact strong and effective AML/CFT laws, and key institutions (courts, law enforcement and supervisory agencies) may be hindered from carrying out their official duties in an effective manner. Development of an AML/CFT Regime in such an environment also requires the establishment of an effective anti-corruption framework. In accordance with the above-mentioned arguments, the decision has been taken to include those Conventions, such as the UN ratification related to Corruption and the OECD Bribery Convention, in the list of needed compulsory ratifications to strengthen legal systems against ML and TF.

According to the FATF:

“Effective implementation of international AML/CFT standards requires not just appropriate legislative, regulatory and organisational structures but a robust system of governance to ensure the integrity of the systems in places’ (FATF-GAFI, 2006, p. 7).

The FATF also points out that:

‘The link between AML/CFT and corruption is two-fold. Firstly, the proceeds of corruption which may be considerable are susceptible to being laundered. Secondly, corruption, and poor governance arising from corrupt institutions (such as the judiciary, the police, or regulatory authorities) and/or individuals, can substantially blunt the effectiveness of an AML/CFT system’ (FATF-GAFI, 2006, p. 7).

Given this, there is a critical need to develop a greater understanding of how weak governance and corruption damage the effectiveness of AML/CFT systems. In addition, an institutional constraint for AMLCFT implementation is to be found in the high start-up and ongoing costs of implementing

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<sup>30</sup> This researcher has dedicated her doctoral thesis to assessing which factors explain jurisdictions’ compliance with AML/CFT Regime. Using a quantitative analysis it was determined in that thesis that corruption and weak governance are the key factors that hamper the implementation of the FATF Recommendations. See chapter 6, Verdugo (2008c).

the AML/CFT standard and lack of resources. Regarding the cost<sup>31</sup> of adopting the fight against ML and FT, Cuellar and Rider point out the following:

‘For the most part, where jurisdictions change their laws and even regulations to conform to some standard such as the FATF’s minimum standard the political authorities in the impacted jurisdiction retain control over budgets, enforcement policy, and prosecutorial discretion (ie, Bussey-discussing the Bahamas apparent failure to prioritize anti-laundering enforcement, despite having signalled an interest in complying with emerging international norms condemning laundering)’ (Cuellar, 2003, p. 440).

‘A serious issue in the minds of many is the price the financial and banking system is required to pay for the strategy of taking the profit out of crime. The costs involved in establishing, maintaining and demonstrating compliance are considerable by any standard. What is clear is that policing the anti-Money Laundering laws and their regulations represents a considerable in-house cost within the financial services and banking industry’ (Rider, 2004, p. 88)

Furthermore, another institutional constraint for the implementation of AML/CFT standards is that of the maintenance of the sovereignty on justice and police matters. To illustrate this problem, we may take the case of the EU. It cannot be denied that the participation in the fight against terrorism and its financing has also proved to be an institutional challenge for the EU.<sup>32</sup>

One could propose the following quotation to summarise this section: ‘There are three domestic factors that influence the development and implementation of CFT policy: (1) the perceptions held by domestic political leader of the costs and benefits of CFT policies; (2) the role of domestic political and social constituencies in influencing the formulation and implementation of CFT policies; and (3) the capacity of States to implement and enforce counter-terrorism finance prescriptions’ (Giraldo *et al.*, 2007, p. 289).

### **Private Actors: The Failure of the Risk Approach and the Impact of High Costs**

We have argued that the effectiveness of the AML/CFT regime is based on harmonising national legislations, for which reason it has sought to universalise the legal requirements of the AML/CFT strategy. Although we have said that legal requirements constitute the basis of the AML/CFT strategy, the core of this strategy lies in the prevention pillar based on the risk approach. Risk approach is understood as the crucial decision for a country to determine which entities and persons

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<sup>31</sup> ‘En el caso de España, donde el blanqueo de dinero mueve cerca de 15.000 millones de euros anuales, el GAFI ha llegado a solicitar el Gobierno que revise su sistema de supervisión sobre las entidades financieras y que se mejore la coordinación de las instituciones que llevan a cabo las inspecciones. De entre las razones que detecta el GAFI sobre las deficiencias en los controles de los bancos destaca una esencial: la falta de recursos del principal organismo encargado de vigilar los mecanismos de supervisión, el Servicio Español de Prevención de Blanqueo de Capitales e Infracciones Monetarias. El Sepblac solo cuenta con 77 profesionales de los cuales 8 son inspectores, 2000 inspectores persiguen el fraude a gran escala pero siempre es un personal muy reducido para supervisar bancos, inmobiliarias, promotoras, sociedades de inversión, joyerías, abogados, casinos y los más de 8000 alcaldes’ (Mazo, 2006, p. 1-2). According to Kochan (2004) ‘The UK government, for example, has advised banks and financial institutions to budget £120 million (182 million euros) collectively to comply with its money-laundering laws. “This is a gross underestimate”, says Martyn Bridges, Director of Bridges and partners (...) “those figures, don’t cover 10% of the true costs. The cost to UK banks would be £1 billion a year, assuming that everyone complied, which they won’t”’ (Kochan, 2004, p. A6).

<sup>32</sup> For detailed explanations of the EU fight against terrorist financing, see EU (2005), ‘Final Report: The Evaluation of National Anti-terrorist Arrangements: Improving National Machinery and Capabilities’, Council of Europe; and EU (2007), ‘Fight against terrorism financing-six monthly report’, Counter-terrorism Coordinator, Council of the European Union, Brussels, p. 10. ‘A tres años del 11-S y ocho meses del 11-M, un informe de la UE muestra graves incumplimientos y enormes lagunas (...) según fuentes de la UE, los socios no dan signos de enmendar el mayor de sus pecados en el ámbito preventivo de la lucha antiterrorista, que es la falta de intercambio de datos policiales y de inteligencia: La información no fluye. Los Estados no se fían’ (F. Garcia, 2004, ‘Europa sigue atrasada en la lucha antiterrorista’, *La Vanguardia*, Barcelona, p. 11). ‘Secondo i dati di Bruxelles a intralciare il “Piano d’azione” sono i cavilli burocratici e i conflitti di competenza’ (M. Castellaneta, 2005, ‘La lotta al terrore una questione europea’, *Il sole-24 ore el lunedì*, p. 5).



should be covered by which requirements. Sometimes the preventive measures are only applied to financial institutions and only applied to non-financial businesses and professions on a more limited basis.

Most legal scholars and practitioners agree with the idea that the risk approach of the AML/CFT strategy has been unsuccessfully implemented. Freeland (2002) insists 'that despite the efforts done by BCB to respond to FT introducing a risk-based approach and also the FATF's successful initiatives in its member countries, many countries still had no Know Your Customer standards at all' (Pieth, 2002, p. 43). Freeland is one of the most important contributors to accentuate that terrorists will try to hide their true names behind anonymous accounts or 'fronts' making use of trusts, charities, nominees, corporate vehicles, profession intermediaries, and so on, and the present researcher agrees with him that the financial institutions (eg, banking) must make every effort to establish the beneficial owner(s) of all accounts and persons who conduct regular business with it.

He also argues why the implementation of risk approach has been so difficult: 'how conducting customer due diligence is not a simple task and is full of contradictions due to the culture of banking'. In the case of offshore banks, the compliance officer or risk manager in charge of customer due diligence will be in constant conflict with the incentives provided for customer service units dedicated to personal private or offshore banking.

Others argue that another difficulty in the provision of CDD by financial institutions in CFT is to be found in the definition of what constitutes a terrorist or a terrorist organisation. This classification is a difficult issue which the terrorist groups take advantage of.

Another argument for the failure of risk approach has been put forward by Savona. He argued, like Freeland, that 'the greatest obstacles to international co-operation for the prevention of ML are to be found in the area of the identification of the real beneficial owner' (Pieth, 2002, p. 83). He also highlights that the main obstacle is a lack of regulation requiring full information about the real beneficial owner of a public or private limited company, especially when a legal entity is a shareholder or director, or the issuance of bearer sharer is permitted. Savona and Freeland contribute to the understanding of how corporate law could affect the opacity/ transparency of the financial system. The 'domino effect' of company law on other laws and regulations such as criminal, administrative and banking law are, according to them, an additional factor of the failure on the risk approach.

Up to now, we have argued that factors such as the lack of implementation of the risk approach in financial institutions and the different corporate laws within jurisdictions have led to the failure of the prevention pillar. Now we shall argue that this failure is partially due to misguided efforts to implement the same risk approach policy in countries with disparate types of economy.

Among those defending this idea is Ware (2004), who states that responding to financial abuse and achieving the stability of the global financial system through preventive measures seems to be more of a crisis reaction than a rational policy, for the AML/CFT is a standardised code applied in developing and developed countries without taking into account the preconditions of governance in each country, thus creating a wide gap between the developed and the developing world because this kind of reforms will add cost and complexity to business transactions.

De Goede (2004), in accordance with the idea of the social and political consequences of the war on terrorist finance, also points out that 'the risk approach policy which seeks to define and classify suspicious transactions and leading intensive surveillance is exacerbating financial exclusion, through more stringent 'know-your-costumer regulation'. Goede (2004) and Passas (2004) argue that the war on terrorist finance is affecting the communities sending informal remittances and that 'cash' is becoming suspect. The present researcher agrees with Goede that the combating of FT strategy seems to be a policy to reduce the use of cash world-wide.

The question that arises here is whether the AML/CFT can be viewed as a balanced solution that avoids unnecessary burdens on the globalised economy. The international initiatives that run the risk approach only constitute a suitable remedy for countries with high-quality financial systems. In fact, it is unrealistic to establish regulations to be implemented by developing countries with unsatisfactory law enforcement structures, poor technology and a lack of financial culture.

The key challenges of implementing standards world-wide across continents and countries that are at very different stages of economic development still remain in place. If the international community attempts to impose a prevention pillar and risk approach that are inappropriate for a country's level of development and national resources, this strategy might have no effect or simply a modest one on these countries' compliance with international standards. The existence of a large gap between countries that attain a high level of compliance with the standards and those that do not could eventually lead to countries being denied access to some financial markets (Johnston *et al.*, 2006).

The failure of the preventive measures seems to indicate the overall incapacity of jurisdictions to orientate the preventive Recommendations towards the risk approach goal rather than that of crime reduction. The preventive Recommendations and the risk approach have only constituted a good remedy for countries with high-quality financial systems and have also created high start-up and ongoing cost to developed and developing countries.

Other two major challenges remain in place. First, in general, the preventive Recommendations have not been applied to all the groups of concerns such as financial institutions, insurance and securities sector and Designated Non-Financial Businesses Professions.

All in all, it can be said that most countries have a low perception of ML and FT risk and a great deal of financial activity is excluded or subject only to limited controls. Consequently, a low flow of information between public and private sectors about CDD may exist wherever the risk is not taken into account.

Other legal scholars agree that the failures of the risk approach are due to the discourse of the IOs. They have accused the FATF of having 'a discourse primarily oriented not so much towards risk management as towards national and institutional obligation to reduce crime facilitation' (Levi *et al.*, 2002, p. 40).

Geiger *et al.* (2007) point out that the results of the existing AML prevention measures are disappointing –crimes closely connected with ML still prosper–. Meanwhile, 'banks being the main actors involved in ML prevention face high burdens' (Geiger *et al.*, 2007, p. 100). Moreover, they admit that the rule-based approach could not follow the new methods and technologies used by money launderers and the regulators failed to 'formulate detailed ML criteria' (Geiger *et al.*, 2007, p. 100).

In line with the failure of regulated approach failure, Ross *et al.* (2007) observe that overregulation, which often replaces regulation, leads to additional costs, inflexibility and poor regulatory performance (Ross *et al.*, 2007, p. 107). As has been discussed in this dissertation, the main focus of AML compliance is placed on financial institutions (banks) rather than the meaning of collective action.

Furthermore, some authors cite reporting overload as the main disadvantage of the regulation. Jackman (2004) notes that 'there is a fine line between regulation and overregulation' (Jackman, 2004, p. 106). He agrees that 'overregulation can worsen the results achieved from ML prevention' (Jackman, 2004, p. 109). But the most important contribution of Jackman is that one important effect of regulation is that the practitioners tend to decrease their willingness to find AML/CFT

solutions. In connection with the argument of excessive regulation, Edwards *et al.* (2004) argue that 'there is a need for the regulator and banks to work as partners' (Edwards *et al.*, 2004, p. 223).

Examples of countries with a rule-based regulation are provided by Pieth (2004). According to him, some large financial centres (UK and US) place more emphasis on an 'early warning system' with the recording of everyday transactions and the reporting of unusual or suspicious circumstances for future strategic and tactical use by the police or similar authorities, whereas in other large financial centres (ie, Switzerland), the AML-system is far less oriented towards data collection for intelligence and law enforcement purposes.

Finally, we should outline that the failure of the prevention pillar could be attributed to cost benefits arguments: that while the cost of ML prevention for the society and financial institutions are high, the benefits are not clearly seen. There is no data on ML showing that an adequate regulatory control reduces the ML taking place. The benefits of compliance are usually seen as 'flowing from the costs that are otherwise avoided' (Harvey, 2004, p. 336). The benefit of compliance lies in the possibility of avoiding severe sanctions from the regulator.

### **What Would be the Most Effective Strategy to Tackle the Financing of Terrorism?**

In conclusion, it is safe to say that terrorist are still able to raise, move, store and access funds with relative ease and the threat terrorist groups pose to the international community could be dramatically increased. The international cooperation is far from being up to the task of efficiently dealing with the financing of terrorism, for the failings pointed out in the present article such as: the failure of deterrent effects, the lack of preventive intelligence and the incapacity to deny terrorist groups easy access to financing them (disrupting tool). The challenges in strengthening the International Regime to Combat the Financing of Terrorism conceal the reality of three tensions that hinder progress in this direction. The first of these tensions lies between financial regulation and political will, while the second tension is that of the difficult interaction between international standards and their domestic implementation. The third tension, operating at the domestic level, occurs between government and financial and non-financial institutions.

The future international cooperation in the fight against the financing of terrorism must not merely stem from the relations between states, but also from enhancing an interaction between domestic and international games and coalitions such as transnational regulatory networks and financial institutions spanning national boundaries. This cooperation model is the only one that may successfully initiate a reliable process of negotiation and socialisation with havens so as to open the possibility for them to become better regulated countries rather than havens.

Against this background, a double step strategy is needed to overcome the failings and discrepancies between countries in building a more coordinated global strategy against the FT. In the first step, the States should recognise that they have failed to pay attention to the adequate criminalisation of FT, to establish a clear approach towards informal transfer systems, to establish consistent freezing of assets and an approach towards international legal cooperation.

This strategy must, first, achieve a common definition of terrorism and a strict definition of the FT; secondly, convince all stakeholders that action is required at the global level; thirdly, ensure true commitment and a resolute political will in CFT; and fourth, take into account the increasing global nexus between crime and terror and its negative effect, in addition to becoming aware of the fact that terrorists continue to use Failed States and jurisdictions which slow down the implementation of the AML/CFT Regime.

It also seems necessary to create a global index of country vulnerability/risk to FT in order to improve the capacity of international community to monitor and control key havens used by terrorist financiers.

To accomplish these objectives, the following measures can be used to put pressure on the entire world system because there still remain loopholes in the area of financial regulation. As the ML/FT problem is global in nature, measures should be once again implemented, in accordance with the FATF, in order to put an end to the detrimental rules and practices evidenced by this paper. More counter-measures such as the negotiations with uncooperative jurisdictions should be started up again when FATF members and non-members fail to cooperate in combating the financing of terrorism. Some norms should be designed to protect economies against money of unlawful origin; specific requirements should be made for financial institutions in FATF members to pay special attention to, or report on, financial transactions conducted with individuals or legal entities having their account at financial institutions established in a 'non-cooperative jurisdiction'; there should be conditioning, restricting, targeting or even prohibiting of financial transactions with non-cooperative jurisdictions.

Part of this process of financial regulation should aim to improve the implementation of the complementary standards of AML/CFT such as those provide by Basle Committee on Banking Regulation, International Association of Insurance Supervisors (IAIS) and International Organisation of Securities Commissions (IOSCO) because they pave the way for the customer due diligence. National regulatory authorities and finance ministers are strongly encouraged to adapt and enhance existing mechanisms for international regulatory and supervisory coordination. The FATF and FATF-Style Regional Bodies are also obliged to establish a non-compliance policy response in the case of a jurisdiction with low rates of integrity standards compliance. The UN should revitalise the awareness-raising campaigns of the Counter-Terrorism Committee, given the significant role of this institution in CFT strategy. In addition, the international community should extend AML/CFT to fight corruption, incorporating new Recommendations focused on the control of corrupted practices in accordance with the 2003 UN Convention. In addition, complementary policies and strategies should be designed at an international level in areas being exploited by terrorist groups since certain aspects are insufficiently covered by the AML/CFT Regimes such as trade, corporate law, oil smuggling, maritime businesses and humanitarian aid and border controls.

A second step would be to redesign the strategy taking into account not only previous weaknesses but also recognising that one size model does not fit all, especially when there are cash economies and failed States involved. The following points must be taken into account when building up the new strategy. First, the design and prioritisation of policy is an important point and it is also problematic because the goals of risk avoidance and related casualties are very difficult to measure. It is necessary to reject the traditional cost benefit analysis since a policy of combating FT consists in managing uncertainty and imprecise threats. Secondly, at this point the risk-based approach to CFT must be redefined and implemented differently, because a high number of Recommendations from international bodies have created a maze of requirements that overlaps efforts and undermines efficiency.

A high level Interagency is needed to lead the national efforts on CFT strategy. Peer evaluation (mutual evaluation report) should be revised, making it comparable in the long run without preventing methodological improvements. International Organisations should study whether it is a necessary technical assistance to start a security sector reform before implementing an International Regime such as the AML/CFT. The policy makers should design a strategy to manage and map different levels of analysis (EU, National and Cross Borders); then they should think about determining the main information requirements of CFT stakeholders. This change of strategy would compel the international organisation to provide clear policy guidance to the private sector.

There is a question of how much information law enforcement agencies should give to the regulated financial sector in order to maximise the efficiency of data collection, and thus contribute to keeping financial institutions informed of the new patterns, indicators and typologies relevant to fighting against Terrorist Financing. The complexity of Terrorist Financing requires a coordination

of public and private sectors, and law enforcement and intelligence agencies need to give advice to financial institutions and designated non financial businesses professions on what kind of data they need.

An enhancement of public cooperation is also necessary. In the case of prosecutions, one of the largest challenges law enforcement faces is that of compiling evidence around a case of terrorism. There is a large amount of information that will never be seen in a courtroom because it cannot be verified. There is a conflict between collecting evidence for courts (law enforcement) and collecting information to inform a government (intelligence agencies). This conflict must be solved by an improved construction of a CFT strategy. Information exchange is another fundamental component of the CFT. There still remain legal barriers when two or more jurisdictions are involved and when gathering information in one country is a criminal offence if data privacy and bank secrecy laws remain in place. This poses many restrictions on which institutions can disclose data in their possession, eg, SWIFT.

The current legal framework is not designed to deal efficiently with the CFT, because financial institutions must comply with five institutions, regulators, law enforcement agencies, internal management and employee conscience, and society. There still exist formal channels not disclosing information and resulting in inefficient and ineffective practices. All these points should be taken into account to genuinely deter FT. Nevertheless, the key that would make it all feasible is to overcome weak governance, for weak governance impedes the development of a domestic Regime on AML/CFT as well as the harmonisation of domestic Regimes, which is the real disease of the efficiency of international regulatory standards.

*Concepción Verdugo-Yepes*

*PhD in Economics and International Law from the University of Barcelona and Milan's Bocconi University, a member of Research Group on International Economic Organisation at the University of Barcelona at the time of writing this Working Paper and currently a Research Officer in the IMF's Financial Integrity Group*

**ANNEX I. Profile of the Overall Compliance of 46 Countries with FATF Recommendations**

| <b>FATF Recommendations</b>                         | <b>Compliant (%)</b> | <b>Largely Compliant (%)</b> | <b>Partially Compliant (%)</b> | <b>Not Compliant (%)</b> | <b>Missing Values (%)</b> | <b>Assessed Jurisdictions in number</b> |
|---|----------------------|------------------------------|--------------------------------|--------------------------|---------------------------|---|
| 1.ML offence  | 6.5                  | 47.8                         | 43.5                           | 2.2                      | 0                         | 46                                      |
| 2.ML offence-mental element and corporate liability | 30.4                 | 41.3                         | 26.1                           | 2.2                      | 0                         | 46                                      |
| 3.Confiscation and provisional measures             | 15.2                 | 50.0                         | 32.6                           | 2.2                      | 0                         | 46                                      |
| 4.Secretcy laws consistent with the Recommendations | 58.7                 | 37.0                         | 4.3                            | 0                        | 0                         | 46                                      |
| 5.Customer due diligence                            | 0                    | 13.0                         | 71.5                           | 15.2                     | 0                         | 46                                      |
| 6.Politically exposed persons                       | 0                    | 19.6                         | 26.1                           | 54.3                     | 0                         | 46                                      |
| 7.Correspondent banking                             | 10.9                 | 21.7                         | 17.4                           | 50.0                     | 0                         | 46                                      |
| 8.New technologies & non face-to face business      | 17.4                 | 19.6                         | 34.8                           | 28.3                     | 0                         | 46                                      |
| 9.Third parties and introducers                     | 13.0                 | 15.2                         | 28.3                           | 17.4                     | 26.1                      | 46                                      |
| 10.Record keeping                                   | 32.6                 | 37.0                         | 26.1                           | 4.3                      | 0                         | 46                                      |
| 11.Unusual transactions                             | 13.0                 | 28.3                         | 37.0                           | 21.7                     | 0                         | 46                                      |
| 12.DNFBP- R.5,6,8-11                                | 0                    | 0                            | 52.2                           | 47.8                     | 0                         | 46                                      |
| 13.Suspicious transaction reporting                 | 6.5                  | 30.4                         | 54.2                           | 10.9                     | 0                         | 46                                      |
| 14. Protection no tipping-off                       | 56.5                 | 21.7                         | 19.6                           | 2.2                      | 0                         | 46                                      |
| 15.Internal controls, compliance& audit             | 6.5                  | 39.1                         | 47.8                           | 6.5                      | 0                         | 46                                      |
| 16.DNFBP-R.13-15&21                                 | 0                    | 6.5                          | 50.0                           | 43.5                     | 0                         | 46                                      |
| 17.Sanctions  | 0                    | 37.0                         | 54.3                           | 8.7                      | 0                         | 46                                      |
| 18.Shell Banks                                      | 26.1                 | 37.0                         | 30.4                           | 6.5                      | 0                         | 46                                      |
| 19.Other forms of reporting                         | 58.7                 | 17.4                         | 8.7                            | 15.2                     | 0                         | 46                                      |
| 20.Other NFBP & secure transaction techniques       | 43.5                 | 19.6                         | 10.9                           | 23.9                     | 2.2                       | 46                                      |
| 21.Special attention for higher risk countries      | 15.2                 | 21.7                         | 32.6                           | 30.4                     | 0                         | 46                                      |
| 22.Foreign branches & subsidiaries                  | 8.7                  | 30.4                         | 30.4                           | 26.1                     | 4.3                       | 46                                      |
| 23.Regulation, supervision and monitoring           | 0                    | 30.4                         | 60.9                           | 8.7                      | 0                         | 46                                      |
| 24.DNFBP- regulation,supervision and monitoring     | 0                    | 8.7                          | 34.8                           | 56.5                     | 0                         | 46                                      |
| 25.Guidelines& feedback                             | 6.5                  | 21.7                         | 39.1                           | 32.6                     | 0                         | 46                                      |
| 26.The FIU  | 6.5                  | 52.2                         | 26.1                           | 15.2                     | 0                         | 46                                      |
| 27.Law enforcement authorities                      | 30.4                 | 37.0                         | 26.1                           | 6.5                      | 0                         | 46                                      |
| 28.Powers of competent authorities                  | 65.2                 | 21.7                         | 13.0                           | 0                        | 0                         | 46                                      |
| 29.Supervisors                                      | 15.2                 | 41.3                         | 39.1                           | 4.3                      | 0                         | 46                                      |
| 30.Resources, integrity and training                | 2.2                  | 43.5                         | 45.7                           | 8.7                      | 0                         | 46                                      |
| 31.National co-operation                            | 15.2                 | 43.5                         | 34.8                           | 6.5                      | 0                         | 46                                      |
| 32.Statitstics                                      | 0                    | 28.3                         | 47.8                           | 23.9                     | 0                         | 46                                      |
| 33.Legal persons beneficial owners                  | 10..9                | 19.6                         | 50.0                           | 19.6                     | 0                         | 46                                      |
| 34.Legal arrangements beneficial owners             | 10.9                 | 13.0                         | 21.7                           | 13.0                     | 41.3                      | 46                                      |
| 35.Convention                                       | 8.7                  | 45.7                         | 45.7                           | 0                        | 0                         | 46                                      |
| 36.Mutual Legal Assistance(MLA)                     | 26.1                 | 52.2                         | 19.6                           | 2.2                      | 0                         | 46                                      |
| 37.Dual criminality                                 | 45.7                 | 34.8                         | 15.2                           | 4.3                      | 0                         | 46                                      |
| 38.MLA on confiscation and freezing                 | 21.7                 | 39.1                         | 34.8                           | 4.3                      | 0                         | 46                                      |
| 39.Extradition                                      | 45.7                 | 39.1                         | 6.5                            | 8.7                      | 0                         | 46                                      |
| 40.Other forms of cooperation                       | 2.2                  | 4.3                          | 2.2                            | 91.3                     | 0                         | 46                                      |

Source: author's calculations using data from mutual evaluations; Verdugo (2008a).

**Annex II. Profile of the Overall Compliance with Nine Special Recommendations on Terrorist Financing**

| Nine Special Recommendations                | Compliant (%) | Largely Compliant (%) | Partially Compliant (%) | Not Compliant (%) | Missing Values (%) | Assessed Jurisdictions in number |
|---|---------------|-----------------------|-------------------------|-------------------|--------------------|----------------------------------|
| SR.I. Implement UN Instruments              | 8.7           | 23.9                  | 52.2                    | 15.2              | 0                  | 46                               |
| SR.II. Criminalise Terrorist Financing      | 8.7           | 32.6                  | 37.0                    | 21.7              | 0                  | 46                               |
| SR.III. Freeze /confiscate terrorist assets | 2.2           | 19.6                  | 50                      | 28.3              | 0                  | 46                               |
| SR.IV. Suspicious transaction report        | 8.7           | 30.4                  | 23.9                    | 37.0              | 0                  | 46                               |
| SR.V. International Cooperation             | 13.0          | 45.7                  | 26.1                    | 15.2              | 0                  | 46                               |
| SV.V.I. Requirements for money transfer     | 15.2          | 32.6                  | 34.8                    | 15.2              | 2.2                | 46                               |
| SR.VII. Wire transfer rules                 | 8.7           | 15.2                  | 34.8                    | 41.3              | 0                  | 46                               |
| SR.VIII. Non-profit organisations           | 10.9          | 19.6                  | 39.1                    | 30.4              | 0                  | 46                               |
| SR.IX. Bearer instruments                   | 6.5           | 8.7                   | 34.8                    | 37.0              | 13.0               | 46                               |

Source: Verdugo (2008a)

**Annex III. The Jurisdictions' Overall Compliance Scores**

| Cod | Jurisdictions      | Overall Compliance AML/CFT Store | Cod | Jurisdictions | Overall Compliance AML/CFT Store |
|-----|--------------------|----------------------------------|-----|---------------|----------------------------------|
| ALB | Albania            | 59                               | NPL | Nepal         | 16                               |
| AUS | Australia          | 77                               | NOR | Norway        | 87                               |
| BHR | Bahrain            | 75                               | PAN | Panama        | 99                               |
| BLR | Belarus            | 54                               | PRY | Paraguay      | 55                               |
| BEL | Belgium            | 109                              | PER | Peru          | 93                               |
| BOL | Bolivia            | 38                               | PRT | Portugal      | 93                               |
| BRN | Brunei             | 55                               | SAM | Samoa         | 40                               |
| CHL | Chile              | 73                               | SVK | Slovakia      | 50                               |
| COL | Colombia           | 80                               | SVN | Slovenia      | 100                              |
| CYP | Cyprus             | 105                              | ESP | Spain         | 86                               |
| DNK | Denmark            | 73                               | LKA | Sri Lanka     | 41                               |
| DOM | Dominican Republic | 43                               | SDN | Sudan         | 22                               |
| FJI | Fiji               | 67                               | SWE | Sweden        | 76                               |
| GIB | Gibraltar          | 92                               | CHE | Switzerland   | 88                               |
| HUN | Hungary            | 112                              | SYR | Syria         | 57                               |
| ISL | Iceland            | 70                               | TUR | Turkey        | 55                               |
| IND | India              | 53                               | URY | Uruguay       | 52                               |
| IRL | Ireland            | 87                               | USA | US            | 103                              |
| ITA | Italy              | 92                               | VUT | Vanuatu       | 49                               |
| JAM | Jamaica            | 76                               | GRB | UK            | 109                              |
| LVA | Latvia             | 79                               | GRC | Greece        | 49                               |
| LTU | Lithuania          | 87                               | CHN | China         | 68                               |
| MRT | Mauritania         | 44                               | GEO | Georgia       | 57                               |

Source: Verdugo (2008a).

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