Editorial

Compliance, effectiveness and the rise of the public private partnership

Money laundering and terrorist financing target economic and financial structures and transactions to move, hide or disguise the proceeds of crime or the financing of terrorists. Countermeasures (sometimes known as AML/CFT measures) focus on access to and use of the financial system and create a host of obligations for private sector financial institutions [1]. These obligations are defined and promulgated through international standards which set out design principles that guide the shape of national AML/CFT laws and regulatory measures.

The Financial Action Task Force (FATF), formed under direction from the G7 in 1989, is the international standard setter for financial crime countermeasures. These standards, implemented in over 190 countries, are frequently revised and amended with participating nations subject to public evaluations of their technical compliance with the standards on a periodic basis. Although the standards framework is more than 30 years old, it is unclear how effectively private sector financial institutions have been engaged in these countermeasures and the extent to which underlying predicate crimes or terrorism has been reduced or contained. Significant fines and other regulatory enforcement actions suggest that institutional compliance levels may be poor. Compliance however is only part of the issue. There are unanswered questions regarding the soundness of the overall strategy.

Private sector entities are predominately engaged in the countermeasures strategy through national legislation enforced via a regulatory model [2]. This approach is supported by a chain of logic as follows:

- Criminals will seek to avoid detection through using the financial system in increasingly complex ways.
- Detection and disruption by the private sector is therefore reliant on the application of due diligence by the institutions on their customer and provision of financial intelligence which enables public sector intervention.
- To ensure the private sector establishes appropriate practices, states shall be required to issue regulation (and appoint adequate supervision measures).
- Private sector compliance with this regulation, under supervision and guidance, will enhance public sector capabilities and serve to reduce use of the financial system by criminals.
- A reduction in financial crime shall lead (ultimately) to a reduction in the predicate crimes in participating nations.

Important to this reasoning is that the global strategy is implemented locally, i.e. the international standards are converted into local legislation by each participating state, and it is these local laws that create private sector compliance obligations. Equally critical to the arc of logic is an understanding of the two principle obligations placed upon the private sector institutions. Firstly, the financial institutions provide a sentinel or gatekeeper function. To achieve this, the institution must know enough about their customer through performing adequate due diligence and assessing the risk of potential financial crime. Secondly, where this gatekeeping has failed, institutions must report on specific "suspicious" transaction activity for customers or ensure adequate knowledge of customers is retained to address queries directed from law enforcement in response to suspicions of

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criminal activity. In summary, the private sector must keep criminal funds out of the financial system, and where they have been unable to do so, they must report this matter to the appropriate authorities.

It is proposed that the due diligence and intelligence/reporting obligations represent a flawed strategy that rests on untested or weak assumptions:

- At the local level, it is assumed that the financial institution will follow the rules and laws set by the domestic regulators and competent authorities.
- It is further assumed that institutions will be competent enough at meeting these obligations, and that due diligence practices will deter or disrupt many criminal organisations.
- Where the due diligence practices do not deter or disrupt, it is expected that the institutions will be effective in the monitoring of their customer behaviour to identify criminal activity.
- It expected that this identified criminal activity would be reported to law enforcement or other agencies.
- It is then assumed that law enforcement agencies would take action on the intelligence provided, and this action would result in a reduction in crime.

An overall objective of crime reduction is therefore only achieved if the above chain of assumptions and expectations is equally promulgated across the financial system for all institutions in all countries.

Testing the validity of these assumptions, and the overall soundness of the countermeasures strategy, has been problematic. Since the 1990s, the FATF has used a process of "mutual evaluation" between countries to assess the degree of "compliance" with the international standards at a national level. Results from these evaluations were inconclusive but created doubt that a compliance-based approach was sufficient to achieve an objective of crime reduction. The FATF 2013 mutual evaluation methodology sought to address this uncertainty by including an assessment of "effectiveness" in addition to evaluating (the normal) compliance with international standards. Analysis of results from over 60 of these country-level evaluations has shown there to be only a weak correlation between a technically compliant program and effectiveness.

These results from a national-level assessment also challenge the above assumptions that private sector compliance to state-based regulation will produce a reduction in financial crime. Fundamental to this challenge is an emphasis on the *qualitative* aspect of the countermeasures deployed by the private sector with their due diligence and reporting focus. It is not enough for an institution to use internal policies addressing these control obligations. Participants must actually be *good at* these control functions, and this technical expertise must be consistently applied across multiple entities in all jurisdictions. Continued regulatory breaches by large institutions, and fines or other penalties for non-compliance, suggest that this equal distribution of technical capability across the sector has not happened.

Regulatory models for private sector engagement are not restricted to financial crime countermeasures, have been around for some time and equally rely on compliance to achieve a desired outcome or fixed objective. In the case of the AML/CFT regime, however, the overall objective is a reduction in crime achieved via controlling access to the financial system. The agencies of the state have placed significant accountability for crime reduction into the hands of a private sector compliance officer. This accountability is further reliant on the technical skill and ability of these private sector compliance officers in addressing the

complex subjects of criminal detection and control. Failure by these compliance officers to be "good at" detection and control activities will of course expose the private institution to regulatory fines and penalties and exposes the rest of global society to an increased risk of organised criminality and terrorism.

Public and private agencies and participants have recognised these limitations within the model. Over the past five years, there has been greater sharing and collaboration between the state and the private sector. Current trends are directed towards the use of public–private partnerships (PPP) to formalise this sharing and collaboration. Numerous examples of successful PPP relationships exist, and results have demonstrated the value in placing the criminal detection capability of the professional law enforcement officer alongside the proficient compliance officer and financial investigator. Many jurisdictions are now looking to emulate this success by creating their own versions of these PPP while catering for variation in criminal threat, private sector expertise and the local legal frameworks that exist.

Caution must be exercised in the enthusiastic expansion of this PPP trend. In the first instance, in jurisdictions with a weak rule of law, a PPP seconds the compliance professional further into the service of potentially corrupt officials. Secondly, original legal frameworks established under the FATF standards were generally not flexible enough to allow for state/non-state collaboration. In many cases, this was because the non-state actors (i.e. "the banks") were seen to be the perpetrators of criminal activity. The frameworks established therefore were to provide a check on the performance of the institutions and may not easily lend themselves to an equal partnership. Finally, the engagement model for PPP needs to be carefully examined. As the evidence is beginning to show, creating additional regulatory requirements for private sector participation will not guarantee an effective capability to be established.

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Notes

1. Anti-money laundering/countering the financing of terrorism.
2. Defined as financial institutions which includes, but is not limited to, Banks.