Blocking International Terrorism
A summary of recent initiatives by various international financial bodies

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Introduction

Since the tragic events of September 11th, uncovering and blocking the use of international financial mechanisms to fund terrorist activities has become a central concern for international financial bodies, especially those concerned with overseeing the operation of the international financial system. Still, even before this attack, institutions like the IMF and OECD had policies to deal with two major concerns regarding the international financial architecture: instability and the potential for illicit activities, especially money-laundering – the processing of criminal proceeds in order to disguise their illegal origin. Initiatives taken after September 11th have thus been largely grafted on to three already existing types of programme aimed at dealing with these two concerns: (i) programmes dealing directly with instability; (ii) those dealing with the regulation of tax havens and offshore centres, and (iii) those dealing directly with money laundering. The major difficulty in dealing with financing terrorism, as opposed to money laundering, is that no crime is committed until after the financing has taken place. Money-laundering, presents the opposite situation which makes controlling it relatively less complicated. Confronting the problem of financing terrorism is thus more difficult than that of money-laundering, which is itself already difficult enough.

The organisations that we will look at here are the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD) and the Financial Action Task Force (FATF), also known as the Groupe d'action financière sur le blanchiment de capitaux (GAFI). The last is a relatively new organisation set up on the initiative of the Financial Stability Forum (FSF) of the G7 countries, with its secretariat at the OECD headquarters in Paris (although it is a separate organisation from the OECD). The FATF is an intergovernmental body whose purpose is the development and promotion of policies to combat money laundering. These policies aim to prevent such proceeds from being utilised in future criminal activities and from affecting legitimate economic activities. The FATF membership consists of 29 countries and two international organisations (the European Commission and the Gulf Co-operation Council).

In this summary the following documents of the IMF, OECD and FATF are treated:

· FATF: Forty Recommendations (1990 / 1996), Special Recommendations on Terrorist Financing (31.10.01) and Review of the FATF Forty Recommendations Consultation Paper (30.05.02)

· OECD: Project on Harmful Tax Practices 2001 (1998 and 2000 reports also mentioned)

· IMF: "Offshore Financial Center Program: A Progress Report", March 28th 2002 and "Offshore Financial Centers: The Role of the IMF" June 2000; Intensified Fund

Involvement in Anti-Money Laundering and Combating Financing of Terrorism (AML/CFT), November 5th 2001.

FATF

1. Forty Recommendations

This document, first produced in 1990 and revised in 1996, provides the basis for the activities of the FATF. It outlines "principles of action" rather than specific measures, since countries have to implement them within their own particular financial and legal systems. In order to ensure implementation, FATF members carry out an annual self assessment, which is complemented by a more detailed mutual evaluation procedure. The FATF itself carries out periodical cross country reviews of the implementation of particular principles or measures.

The Forty Recommendations are split into 4 sections:

A. General Framework of the Recommendations (recommendations 1 – 3);

B. Role of National Legal Systems in Combating Money Laundering (recommendations 4 – 7);

C. Role of the Financial System in Combating Money Laundering (recommendations 8 – 29);

D. Strengthening of International Co-operation (recommendations 30 – 40).

Section A

Countries should "take immediate steps to ratify and implement" the 1988 UN Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, known as the Vienna Convention (recommendation 1). Laws on financial secrecy should not impede the implementation of the FATF recommendations, while effective programmes to deal with money laundering should incorporate increased multilateral co-operation and mutual legal assistance, including prosecutions and extradition where possible (recommendations 2 and 3).

Section B

Three recommendations deal with the scope of the criminal offence of money laundering (recommendations 4 – 6) and with provisional measures and confiscation (recommendation 7).

Section C

Two opening recommendations (8 & 9) cover the application of the remaining recommendations of the section (10 – 29) to both banks and non-bank financial institutions and the application of 100 – 21 and 23 to non-financial institutions that undertake some financial activities. Countries may decide that anti-money laundering measures may not need to be applied in some cases, as, for instance, when financial activity is carried out on an occasional or limited basis. A long interpretative note accompanies recommendation 8 on the question of the Bureaux de Change and recommendation 9 has an annex listing financial activities undertaken by businesses which are not financial institutions (e.g. financial leasing, money transmission services, life insurance and other investment related insurance).

The remaining recommendations of this section fall under the following sub-headings:

· Customer identification and Record – keeping rules;

- Increased diligence of Financial Institutions;

- Measures to cope with the Problem of Countries with No or Insufficient Anti-Money Laundering Measures;

- Other Measures to Avoid Money Laundering;

- Implementation and the Role of Regulatory and other Administrative Authorities.

Customer Identification: financial institutions should not keep anonymous accounts or accounts under obviously fictitious names; they should be required to reveal the identity of a client to "domestic competent authorities" in the event of a criminal investigation; where necessary, they should verify the identity of the customer. Records on transactions should be kept for at least five years and records on the identity of a customer should be kept for at least five years after the account is closed (recommendations 10, 11 &12). Special attention should be paid to the possibility of new technologies aiding anonymity (recommendation 13).

Increased Diligence: financial institutions must be on the lookout for strange financial activity, which they should investigate. If criminal activity is involved, they should be required to report it by law. Two recommendations protect the financial institutions from prosecution if they pass information about transactions or clients to the competent authorities, even if there turns out to have been no criminal activity involved, and allow them to pass on such information without informing the client (16 &17). Financial institutions must adopt anti-money laundering policies (19).

Measures to Cope with Problem Countries: financial institutions with subsidiaries in countries that do not fully apply these recommendations should ensure that their subsidiaries apply them and should be especially vigilant with regard to financial transactions with persons or organisations in these countries.

Other Measures: monitoring cross-border movement of cash; reporting currency transactions above a certain amount to a national central agency; encouraging the general development of non-cash forms of payment in society in general; vigilance and special legal provisions if necessary with regard to shell corporations.

Implementation: competent authorities need to ensure that proper anti-money laundering policies are in place in financial institutions; they need to ensure their effective implementation and to issue general guidelines which also act as an educational tool; they should prevent criminals or their confederates taking control of, or acquiring significant participation in, financial institutions.

Section D

These recommendations are split into two main groups: Administrative Co-operation and Other forms of Co-operation. They cover exchange of general information and of information relating to suspicious activities; the basis and means for co-operation in confiscation, mutual assistance and extradition, and improved mutual assistance on money laundering issues.

2. Special Recommendations on Terrorist Financing

These recommendations, eight in all, are designed to be combined with the existing Forty Recommendations. They were adopted 31st October 2001:

1. Ratification and Implementation of UN instruments, especially the 1999 United Nations International Convention for the Suppression of the Financing of Terrorism and the United Nations Security Council Resolution 1373;

2. Criminalising the financing of terrorism and associated money laundering;

3. Freezing and confiscating terrorist assets, in accord with UN resolutions;

4. Reporting suspicious transactions related to terrorism;

5. International co-operation, on the basis of treaties or other measures, including taking measures to ensure that no "safe haven" is provided for individuals facing charges for terrorism;

6. Alternative remittance: all persons or legal entities involved in transfer of money or other valuables must be licensed or registered and covered by FATF recommendations, otherwise they should be liable to administrative, civil or criminal sanctions;

7. Wire transfers: clear information about the source should be required, with especial vigilance for any transfer where originator information is not complete;

8. Non-profit organisations: laws governing them should be reviewed so that they are not able to pose as a front for terrorist activities.

Much of these eight recommendations repeats what is in the Forty recommendations, with the exception of the last one, which is new.

3. Review of the FATF Forty Recommendations

Due to recent developments and the growing experience worldwide in combating money laundering, the FATF has launched a review process of the Forty Recommendations. The Consultation paper they have produced is over 100 pages long, so we will only mention the areas that are particularly important in the review.

1. Customer identification and due diligence, suspicious transaction reporting and regulation and supervision: this area is developing. The recommendations need to be updated to take into account these new developments.

2. Corporate vehicles: there is often still significant difficulty in finding out who the real owners of particular types of corporate entity are. Particular attention is being paid to bearer shares and trusts.

3. Non-financial businesses and professions: the FATF is considering whether its recommendations should be extended to the following organisations or professions which can also be used for laundering criminal funds:

- Casinos and other gambling businesses;
- Dealers in real estate and other high value items;
- Company and trust service providers;
- Lawyers;
- Notaries;
- Accounting professionals;

· Investment advisors.

The FATF welcomed written submissions on this consultation paper until 30th September 2002. At present, all these submissions are available on their website for anyone interested in seeing how the review process is progressing (www.fatf-gafi.org).

OECD

In the past, tax policy could be developed at the level of the nation with regard largely to the domestic economic and social situation. Governments could choose levels of taxation aimed to improve the allocation of resources in society and to fund publicly provided goods primarily in the light of local concerns. The international dimension was never absent, but its effect was limited. With the advent of deregulation and globalisation, however, and the growth of multinational enterprises, companies and individuals can now exploit differing tax structures to minimise or completely avoid paying tax without much difficulty. The OECD is particularly concerned about the distorting effects on trade and investment that such exploitation brings about, especially insofar as it means that the burden of local tax bases shifts from mobile factors such as capital to relatively immobile ones like land and labour, and to consumption. Individuals and companies that do not pay local taxes are "free riders", benefiting from the public services provided by the government, but not paying for them. One of the complicating factors in the discussion is that the OECD does not want to say that all countries should have the same or very similar tax structure, since they may have legitimate reasons for maintaining particular aspects of their fiscal systems, but at the same time, it does want to avoid "harmful" competition between countries where the distorting effects mentioned above start to be significant. On this point, some judgement has to be made, about which not everyone will agree. As the report says:

"Tax competition and the interaction of tax systems can have effects that some countries view as negative or harmful but others may not. For example, one country may view investment incentives as a policy instrument to stimulate new investment, while another may view investment incentives as diverting real income from one country to another. In the context of this last effect, countries with specific structural disadvantages, such as poor geographical location, lack of natural resources, etc., frequently consider that special tax incentives or tax regimes are necessary to offset non-tax disadvantages, including any additional cost from locating in such areas. Similarly, within countries, peripheral regions often experience difficulties in promoting their development and may, at certain stages in this development, benefit from more attractive tax regimes or tax incentives for certain activities. This outcome, in itself, recognises that many factors affect the overall competitive position of a country. Although the international community may have concerns about potential spillover effects, these decisions may be justifiable from the point of view of the country in question" (p.15).

The report also wants to allow investors the possibility to invest where there are lower tax rates, and fewer public services, or higher rates and better services. Although this is not said explicitly, such investment seems to be in real activities, rather than in purely financial transactions. Tax incentives to promote real investment, therefore, are not considered to be a form of unfair or harmful tax competition.

"Harmful" effects of a particular country's tax system on another country may also arise unintentionally; such effects can be put right unilaterally or bilaterally, or by using the procedures for dealing with harmful tax practices put forward by the OECD. A different situation arises where a country specifically aims to redirect capital towards itself by "bidding aggressively" for it, thereby undermining the tax base of the home country.

Some have described this effect as "poaching" as the tax base "rightly" belongs to the other country. Practices of this sort can appropriately be labelled harmful tax competition as they do not reflect different judgements about the appropriate level of taxes and public outlays or the appropriate mix of taxes in a particular economy, which are aspects of every country's sovereignty in fiscal matters, but are, in effect, tailored to attract investment or savings originating elsewhere or to facilitate the avoidance of other countries' taxes.

This case constitutes that of a tax haven or a deliberately harmful tax practice. Such tax regimes are harmful because they undermine the integrity and fairness of the tax structure, discourage the payment of taxes in general, create the need for governments to overtax some components of the tax base to make up for tax loss elsewhere and increase the administrative costs of collecting taxes. Some tax regimes may not have all these negative effects, putting them in a kind of "grey area". Where all these negative effects are present and are substantial, then the country can be considered to be sponsoring a form of harmful tax competition.

According to the report, the following four criteria often characterise a tax haven (but see below for a later development in the definition):

No or nominal taxes

Lack of effective exchange information

Lack of transparency

No substantial activities

These factors are often coupled with attempts to attract non-residents to invest in the country as a means of avoiding taxes in the country of residence.

A harmful tax practice or regime is characterised by similar factors, but only in a particular industry or location, and is often applied only to non-residents or is otherwise "ring-fenced" (that is, isolated from the domestic economy) in countries which, apart from these practices, have "normal" tax regimes. As the report says:

"Many OECD Member and non-member countries have already established or are considering establishing preferential tax regimes to attract highly mobile financial and other service activities. These regimes generally provide a favourable location for holding passive investments or for booking paper profits. In many cases, the regime may have been designed specifically to act as a conduit for routing capital flows across borders. These regimes may be found in the general tax code or in administrative practices, or they may have been established by special tax and non-tax legislation outside the framework of the general tax system" (p.25).

Usually these regimes exist to attract mobile capital, such as booking of profits, when there is no domestic demand for the activity whose profits are booked in the country. In such cases, it seems clear that if the advantageous tax situation did not exist, the booking of profit or flow of investment would not pass through that country.

The fundamental characteristic of both a tax haven and a harmful tax practice is that of low or zero tax rates; the other characteristics may not all be present in a particular case and yet the country or practice will still usually be regarded as a haven or harmful practice.

In the report, several proposals are made with the objective of "reducing the distortionary influence of taxation on the location of mobile financial and service activities, thereby promoting fair competition for real economic activities" (p. 9). The report continues: "If governments can agree that these location decisions should be driven by economic considerations and not primarily by tax factors, this will help move towards the "level playing field" which is so essential to the continued expansion of global economic growth" (p. 9).

Among the proposals the report makes are the following:

To establish Guidelines on Harmful Preferential Tax Regimes;

To create a forum on Harmful Tax Practices.

The 2000 report gives an updated list of countries considered, according to OECD criteria, as tax havens or as operating, at least in some sectors of the economy, harmful tax regimes. 35 jurisdictions were classed as tax havens. Since then, many of these countries have agreed to begin to implement greater transparency in their financial systems and to share information with other jurisdictions. These countries are known as "committed jurisdictions". In the most recent Tax Haven update, only 7 countries (as of 18.04.02) which had been included in the 2000 list still had not committed to transparency and effective exchange of information:

Andorra

The Principality of Liechtenstein

Liberia

The Principality of Monaco

The Republic of the Marshall Islands

The Republic of Nauru

The Republic of Vanuatu

As regards potentially harmful tax regimes, the 2000 report identified 47 in OECD countries. Since the 2000 report, most effort has been devoted to dealing with the tax haven issue; no update is given on the number of harmful tax regimes in OECD member countries.

Some changes to the definition of a tax haven were introduced in the 2001 Progress Report of the OECD's Project on Harmful Tax Practices.i Firstly, it insists that low tax rates are not sufficient to characterise a haven:

The no or nominal tax criterion is not sufficient, by itself, to result in characterisation as a tax haven. The OECD recognises that every jurisdiction has a right to determine whether to impose direct taxes and, if so, to determine the appropriate rate. An analysis of the other key factors is needed for a jurisdiction to be considered a tax haven (n.16).

Secondly, in the dialogue that took place after the 2000 report, a modification was introduced as regards the significance of the fourth criterion for designating a tax haven, no substantial activities. Although this still forms part of the definition of a tax haven, the OECD is no longer aiming to get countries to commit to changing themselves with regard to this criterion:

"The 1998 Report indicates that the lack of substantial activities is one of the criteria to be applied in identifying a jurisdiction as a tax haven. However, the determination of whether local activities are sufficiently substantial is difficult... Consequently, in interpreting the no substantial activities criterion, the Forum sought to determine whether there were factors that discouraged substantial domestic activities. In the light of the discussions with the jurisdictions, the Committee concluded that it should not use this method to determine whether or not a tax haven is uncooperative." (n.27)

Thus the Committee has decided that “commitments will be sought only with respect to the transparency and effective exchange of information criteria to determine which jurisdictions are considered uncooperative tax havens” (n.28).

As a result of this change in definition, the 28 countries that have committed to a dialogue with the OECD over potential harmful tax practices (ie not the 7 that are considered “uncooperative” by the OECD) have committed to making their jurisdictions more transparent and to making the exchange of information with other jurisdictions more effective.ii

The OECD has also planned to introduce a framework of co-ordinated defence measures against harmful tax practices where no co-operation was forthcoming from the tax haven involved, with each OECD member free to choose how and when to enforce defensive measures. For the time being, however, no defensive measures have been put in place.

IMF

Two main initiatives of the IMF interest us here. Firstly, there is the Offshore Financial Center (OFC) Program, initiated in mid-2000 and with a progress report in March 2002. Secondly there is the Anti-Money Laundering and Combating Financing of Terrorism (AML/CFT) Initiative. The second activity overlaps significantly with the work of the FATF, whereas that of the first overlaps significantly with OECD work on tax havens, although in this case it has a wider brief than the OECD project.

Offshore Financial Center Program

This program was initiated in July 2000 as part of the IMF’s work on financial stability. It is designed to address “potential vulnerabilities in financial systems by identifying gaps in supervision and improving the coverage of statistics on the activities of the OFCs in financial markets. According to the 2000 report, “Offshore finance can be defined as the provision of financial services by banks and other agents to non-residents, including the bank intermediation role of taking deposits from non-residents and lending to non-residents. Other services provided include fund management, insurance, trust business, asset protection, corporate planning and tax planning” (n.2). The OFC assessment program consists in identifying gaps in national and global supervisory and regulatory networks, promoting actions by jurisdictions and providing a structure for planning and delivering technical assistance to address the gaps.

Anti-Money Laundering and Combating Financing of Terrorism (AML/CFT) Initiative

The IMF had already been working on this initiative before the events of September 11th, but since then, the program has been intensified. An important distinction between money laundering and financing terrorism is that in the first case, money has been derived from an illicit activity, whereas in financing terrorism, the illegal activity comes after the financial transactions, where the source of the funds may be entirely legitimate. Still, improving transparency and the effective sharing of information would be important in dealing with both issues. One of the main aims of the program is to fill the "critical information gaps" that exist as regards the monitoring of financial activities.

The documents discussed in this article can be accessed at the following websites:

www.fatf-gafi.org

www.oecd.org

www.imf.org

NOTES

i The account here concentrates on one part of the report: Part IV. Tax Haven Work.

ii Paragraphs 37 and 38 of the report detail what these commitments mean.