



# REASSESSING THE RISK BASED ANTI-MONEY LAUNDERING STRATEGY

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*The adoption of the risk-based money laundering detection system across Europe has given increased investigative responsibility to banks. For countries where banks are often collaborators in the money laundering schemes, the criminals are in effect investigating themselves. Governments in these countries must reassess their risk-based strategies, and with the help of the EU, increase the means of regulation to stem the flow of billions of illicit Euros.*

It has been five years since the Third EU Anti-Money Laundering (AML) Directive came into operation, which included the adoption of the risk-based AML regulation strategy across Europe. The new system is lauded as a vast improvement to the bureaucratic and inflexible rule-based system. However, five years later, it is necessary to implement policy for increased government oversight and pressure in countries where money laundering continues to be a problem.

Strong evidence indicates that Eastern European banks were involved in laundering illegal money from Russia into the rest of Europe. The Baltic States, for example, are the first stop for Russian and Ukrainian illicit and stolen capital. The Vanagels Connection, a cross-border money laundering and offshore network that has concealed the origins of millions of illicit euros, has involved numerous Baltic banks. Governments in the eastern member states of the EU have begun to counteract money laundering, but their efforts are lethargic and remain mostly unsuccessful. So, how can the risk-based regulatory system be improved to ensure bank compliance?

## Two Different Strategies, Same Problem

The rule-based system, which was widespread throughout Europe before 2007, relied on clear, formal criteria in which the regulator (the government) would determine whether a transaction was suspicious. All bank transactions over a certain amount, usually around 5,000-10,000 Euros, were forwarded onto the government's regulatory body. The problem with this system was that the government received

suspicious activity reports (SARs) and money launderers learned to break-up their transaction to a value below the quantity threshold to be deemed suspicious, a hoodwink, known as "smurfing" in the banking sector.

Because of the inefficient bureaucracy and high reporting costs of the rule-based system, since 2007, most countries in Europe have adopted a risk-based assessment (RBA) system. In this system banks are ultimately responsible for suspicious transactions and have designed complex computer systems to determine which transactions are most likely to involve laundered money. Thus, in a RBA system, banks are liable and can be prosecuted if they fail to report a transaction that results in a money laundering conviction.

## Crying-Wolf

While RBAs are seen as a more efficient way of regulating money laundering, a few problems prevail particularly for countries with a weak regulatory culture. The first is that banks over-report in order to avoid liability (known as crying-wolf). This has been a major problem within the U.S., where fines are much higher for false positives. It is also a potential problem for smaller countries. In the Baltics, the regulating offices are small and thus their capacity to process reports is limited. Latvia and Estonia for example have similar sized Financial Intelligence Units (FIU), of around 20 individuals, with only a dozen analysts, to investigate SARs, yet Latvia receives over triple the amount SARs of Estonia. Thus, if these countries begin raising fines for non-compliance, an increase of SARs could drown the already fragile system. In other words, the fines would do



more harm than good, potentially increasing the likelihood that money launderers could by-pass the regulatory offices.

## Do We Let Criminals Investigate Themselves?

The second area of concern is that the success of the system depends on how much banks investigate. The banks are privy to unique information. In other words, ideally banks act like investigation teams, turning over evidence of illicit capital to FIUs. In eastern EU states, some banks are not forwarding key evidence on illicit sources, in turn benefiting from the transaction. Because in a RBA system banks are the main providers of evidence, in effect, banks that are laundering money are in charge of their own investigations.

To ensure that suspicious activity is reported to an adequate level, more government oversight is needed, and discussion between the banks and governments should be encouraged. First, government regulators must guarantee that banks are complying with regulations and laws through an industry wide state-run inspection. Other countries in the EU have annual investigations of their banks. Those banks that either have a history of money laundering or have failed an FIU investigation will be under surveillance for a trial period. During this time, employees will be provided with enhanced training, and suspicious activity reporting will be monitored. If regulation improves, the surveillance will be lifted, but the bank will still be pegged for government attention.

In tandem with these industry-wide inspections, the FIU, the central bank and other banks should engage in round-table discussions to identify key problem areas and possible remedies. This could lead to increased transparency and improve the dialogue amongst law enforcers and financial institutions. While these programs may raise the cost for the government, the preventative measures are necessary, ultimately

saving the EU and member states money in the long-term. The tracking and confiscation of laundered money after it has entered the EU financial system is expensive and time consuming. The money must be stopped at the border.

The EU has encouraged a RBA strategy, and so it must ensure that the member states have the ability to carry it out. First, the *European Anti-Fraud Office (OLAF)* must have a presence in the cross-bank investigations, putting pressure on the FIUs and central banks to be vigorous and forthcoming in their examinations. Second, the RBA system is dependent on a well-trained and tenacious FIU. The limited capacity and an apparent lack of training in eastern European states must be addressed. OLAF should provide FIU training operations in Brussels. Further, if FIUs lack resources, the EU needs to supply direct funds in order to hire more analysts and update their analysis systems.

Money laundering is a transnational issue, and thus borders are almost irrelevant. One weak link puts the entire European Union at risk. Thus, the European Commission must ensure that governments are diligent and defiant in their regulation of money laundering. They must use the tools at their disposal, including OLAF, in order to ensure accountability. As billions of Euros are laundered into or through the EU, money laundering continues to be a problem in Europe. It is time for the EU to take charge in high-risk areas.

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