Caleb M Fundanga: The role of the banking sector in combating money laundering

A paper presented by Dr Caleb M Fundanga, Governor of the Bank of Zambia, at a seminar organised by the C and N Centre for Advanced International Studies, Lusaka, Zambia, 23 January 2003.

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Mr Chairman

Distinguished Guests

Ladies and Gentlemen

Allow me first of all to thank you for inviting me to address you on this topic of great importance to the development of our financial system in Zambia – "***the role of the banking sector in combating money laundering".*** I have every reason to believe that your training in the last couple of days has provided an opportunity for you to share with the resource persons valuable insights on the subjects you have covered.

Mr Chairman, the scourge of money laundering is not new to mankind. Despite money laundering being topical in policy discussions nowadays and on the minds of supervisors and regulators like the Bank of Zambia, the scourge itself has a long history and could be as old as the history of organised trade. Nonetheless, in spite of the fundamentals of the crime remaining, largely, the same as in the olden days, recent advances in technology and globalisation have offered and will continue to offer more sophisticated means to convert ill-gotten proceeds into legally acceptable financial assets.

In recent times, money laundering has grown into real big business. For instance, the *Economist magazine* estimated that about USD 500 billion to USD 1.5 trillion is laundered through banks each year. Further, the Financial Action Task Force (FATF) - an intergovernmental organization under the auspices of the Organisation for Economic Co-operation and Development (OECD) also estimates money laundering to be in the ranges of USD 590 billion to US1.5 trillion. As a percentage of world economic output, money laundering accounts for about 2% to 5%. Obviously, given the secrecy and the illegal nature of this business, it is difficult to tell exactly the extent of money laundering. Nevertheless, these figures give us an indication of the magnitude of the problem.

In this regard, financial institutions, in particular, banks provide a conduit through which money (including laundered money) flows. Because of this, the financial system is the focal point of anti-money laundering initiatives because dirty money is most visible when it is first introduced into the financial system.

Ladies and Gentlemen, before I proceed in discussing the various aspects of money laundering including stages in money laundering, its effects on the economy, the global and local initiatives to fight money laundering and the role that banks can play in combating money laundering, allow me to define what money laundering is.

For the purposes of my presentation today, I shall define money laundering as the method of hiding, mixing and disguising the proceeds of criminal activities through legally operating institutions for the purpose of destroying the origins of the proceeds.

Mr Chairman, it is clear from the definition that money laundering is a tool that is used by people involved in illegal activities, such as drug trafficking, organised crime, tax-evading, political bribery and above all, corruption. In addition, the events of September 11th have added another dimension to the problem of money laundering and brought to light the synonymity between money laundering and terrorism.

What then are the stages in money laundering? Though the money laundering process seems so complicated, it usually follows a traceable pattern and three distinct stages can be identified. These are:

- Placement Stage. This it involves the disposal of cash proceeds of the illegal activity. It is at this stage that the proceeds are introduced into the financial system in a manner that avoids detection by the banks and the authorities. At this stage criminals use techniques like depositing large amounts of money in several smaller batches so as to avoid suspicion and detection.

- Layering Stage. This is when the true character of the cash proceeds of the illegal activities is hidden through a series of transactions in order to erase the audit trail. This is done by transferring this money to off-shore banking centres with strict secrecy laws, or to bearer bonds, and/or shell holding companies and accounts held in the name of nominees.
- The last stage is the Integration Stage where the successfully laundered money is integrated into the financial system.

Money laundering has a wide range of adverse effects on any country's economic, political and social structures. Since laundered money passes through the financial system, money laundering also has several effects on the financial systems as a whole and banks in particular. Some of the effects include:

- First, undermining legitimate private sector efforts. Money launderers use front companies, to disguise the proceeds of illicit activities and in the process hide the ill-gotten gains. These companies have access to substantial illicit funds, therefore allowing them to subsidize the front company and offer it's products and services at levels below market rates. At times they quote prices, which are below production cost. This explains why front companies have competitive advantage over companies that source their funding from the financial markets. This makes it difficult, if not impossible, for legitimate business to compete against such companies. This situation may lead to the crowding out of legitimate private sector businesses by criminal entities. Clearly, such criminal enterprises would not adhere to good corporate governance practices as legitimate businesses would.
- Second, loss of control of economic policy. As already alluded to, the magnitude of money laundering is between 2% to 5% of world output. In most developing economies, like ours, these proceeds may dwarf government budgets, resulting in loss of control over economic policy by such governments.
- Third, money laundering can also affect currencies and interest rates as launderers reinvest their funds where their schemes are less likely to be detected rather than where rates of return are higher. Money laundering can also increase the threat of monetary instability due to the misallocation of resources. In this regard, money laundering may result in inexplicable changes in money demand and increased volatility of international capital flows, interest and exchange rates. The unpredictable nature of money laundering, coupled with the attendant loss of policy control, may make sound economic policy difficult to achieve.
- Fourth, money laundering could lead to economic distortion and instability. Since money launderers are not interested in profit generation from their investment but rather in protecting their proceeds, they will invest their funds in activities that are not necessarily economically beneficial to the country where the funds are located. Further, to the extent that money laundering and financial crime redirect funds from sound investments to low-quality investments that hide their proceeds, economic growth can suffer. In some countries for example, entire industries, such as construction and hotels, have been financed not because of actual demand, but because of the short-term interests of money launderers. When these industries no longer suit the money launderers' scheme of things, they abandon them, causing a collapse of these sectors and immense damage to economies.
- Fifth, money laundering could lead to loss of revenue. Money laundering makes tax collection efforts difficult, thus leading to decline in tax revenues. The loss of revenue means government setting higher tax rates than would normally be the case.
- Sixth, money laundering could lead to risks to privatisation programmes. Money laundering poses a threat to governments' economic reform efforts, especially privatization of state owned enterprises. Money launderers have the financial power to out-bid legitimate investors. In addition, while privatisation initiatives are often economically beneficial, they can also serve as a vehicle to launder funds. Criminals have been known to purchase privatised banks, resorts, etc to hide their illicit proceeds and farther their criminal activities. Unfortunately, developing countries like Zambia risk being exposed to the threat of money laundering because in the process of attracting investments, they become more vulnerable to accepting laundered money.
- Seven, money laundering could expose any recipient country to reputation risk. In today's global economy, nations cannot afford to have their reputations eroded by associating

themselves with money laundering activities. Money laundering and other crimes erode confidence in financial markets, and the negative reputation resulting from these activities diminishes legitimate global opportunities available to any country and this could slow sustainable economic growth.

Ladies and Gentlemen, what I have just elaborated are the adverse effects of money laundering on any economy in the world. Allow me now to look at the effects of money laundering on the banking sector. As you may be aware, due to banks' confidentiality principle and their capability to handle huge cashless transactions, and transmit funds efficiently, they are normally the targets of money laundering activities. In doing so, banks also suffer serious consequences from money laundering, which include:

- First, reputation risk - banks become vulnerable to reputation risk because they easily become a vehicle for or a victim of illegal activities perpetuated by their customers. Once banks are associated with such activities, their reputation in the market becomes tainted and they risk losing customers. For instance, in Zambia, the closure of one bank was as a result of allegations that the bank maintained accounts keeping proceeds of drug money. Banks therefore, need to protect themselves by continuously and vigilantly evaluating their customer base. The quest to mobilise deposits and improve liquidity must not be an overriding factor to accepting money from questionable sources.
- Second, legal risk - banks may become subject of lawsuits resulting from failure to observe 'know your customer' standards or from failure to practice due diligence in customer evaluation and acceptance. As a result of this, banks can suffer from criminal liabilities, supervisory fines and other penalties.
- Third, concentration risk - banks are expected to have information systems to identify credit concentrations and to set prudential limits to restrict exposures to single borrowers or groups of related borrowers. The challenge for banks therefore is to adopt vigorous programs for the detection of suspicious transactions, since failure to report such transactions under the new money laundering legislation may subject the bank to criminal sanctions.
- Fourth, lack of anti-money laundering practices in a bank may also affect it's relationships with correspondent banks because reputable international banks would not want to be associated with banks that do not practice basic anti-money laundering techniques, and therefore be a threaten to their own operations.
- Fifth, money laundering compromises the corporate governance structure of banks. This is an area of concern especially among the small banks when it comes to deposit mobilisation and customer selection.

Mr Chairman, the increasing integration of financial systems means that money launderers can now make use of the financial system to hide the proceeds of the illegal activities easily. Launderers are now able to quickly move illicit money between national jurisdictions, therefore complicating the task of tracing and confiscating these assets.

Further, differences in money laundering legislation and in the implementation of international standards such as, know your customer regulations, customer identification and secrecy laws have led to regulatory arbitrage. This has worked to the advantage of money launderers because they can move the proceeds of their activities to less regulated territories where there are lax laws. Therefore, to avoid launderers from taking advantage of the weaknesses in the application of international law, many governments have decided to co-operate in order to combat money laundering. In this regard, the most notable international initiatives/responses to money laundering include:

- First, the Financial Action Task Force (FATF). The FATF is a 26 member intergovernmental, policymaking body that was established in 1989 to guide the implementation of anti money laundering measures in the aftermath of the 1988 UN Drugs Convention. Its membership includes the major financial centres of Europe, North America and Asia. The FATF has come up with 40 recommendations which member countries are expected to adopt. These are designed for universal application and cover the criminal justice system and law enforcement, the financial system; it's regulation and international cooperation.
- Second, the Basel Committee of Banking Supervision. The main thrust of regulatory response to money laundering has been to stop dirty money from entering the banking system and to make sure that it is traceable when it occurs. The Basel Committee, a grouping of the worlds leading bank supervisors has so far come up with three guidelines for

banks in combating money laundering, namely: *'The Prevention of Criminal Use of the Banking System for the purpose of Money Laundering' (1988),* the *'Core Principles of Effective Banking Supervision' (1997),* and the '*Customer due diligence for banks' (2001).*

- Third, the Wolfsberg Principles. The Wolfberg Principles came into force in 2000 and are an industry response to the threat of money laundering. They are an agreement among eleven major international private banks (which account for at least a third of the world private banking funds) to guide the conduct of international private banking. Essentially, the Principles seek to control money laundering by cutting across the multiplicity of jurisdictional issues and addressing the serious reputation damage they were suffering in the media because of money laundering.

Ladies and Gentlemen, allow me now to discuss our local initiatives/responses to money laundering. Admittedly, there has been little activity in the areas of prevention of money laundering in Zambia, until quite recently. This exposed the country to the activities of money launderers because they always seek to operate in countries where there are lax controls. However, the major initiatives in the fight against money laundering, locally, have included:

- Enactment of the Prohibition and Prevention of Money Laundering Act. The Government of Zambia responded to the increase in drug trafficking and money laundering by passing the Prohibition and Prevention of Money Laundering Act in 2001. The Act provides for the disclosure of information by supervisory authorities and of regulated institutions if suspected of money laundering activities. The Act also provides for the forfeiture of property belonging to persons connected to money laundering offences as well as for the prosecution of persons connected to or charged with money laundering offences. The Money Laundering Act places certain obligations on the Bank of Zambia as the supervisory authority. One of these is the issuance of regulations to commercial banks as and when necessary in order to prevent money laundering.

- Regulatory responses. The Governor of the Bank of Zambia is a member of the Anti-Money Laundering Authority, whose main functions are to provide policy directives to the Commissioner of the Drug Enforcement Commission and to advise the Minister of Home Affairs on measures that are required to prevent and detect money-laundering activities in Zambia.

- In order to minimise the likelihood of criminals or their organisations from taking control of or setting up their own banks, the Bank of Zambia as the licensing authority of banks and financial institutions, has put in place a rigorous licensing process, which ensures that only 'fit and proper' persons are allowed to own and manage financial institutions.

- Know Your Customer Directive. Even before the coming into effect of the Prohibition and Prevention of Money Laundering Act, the Bank of Zambia, inline with the Basle Committee's guidelines issued the 'Know Your Customer' Directive in December 1998. The directive outlines the basic procedures that bank managements should put in place within their institutions to prevent criminal use of the banking system. It also places limitations on the amounts of foreign exchange that individuals can transact.

Mr Chairman, the banking sector in Zambia has also not lagged behind in terms of coming up with an industry response to this scourge. The Bankers' Association of Zambia (BAZ) issued the 'Code of Banking Practice in Zambia' in 2002, outlining the Association's commitment to fighting money laundering and complying with the letter and spirit of money laundering in all parts of the world.

Because banks have been identified as the primary focus of money launderers and provide an entry point for laundered money into the financial system, most efforts to combat this scourge are targeted towards banks. Under the money-laundering Act, banks have certain obligations, which are placed upon them by the law. These include:

- To keep identification record of its customers for a period of ten years. This is aimed at safeguarding the documentary evidence to prove that the financial institution has sufficient knowledge of its clients.

- To report to the Money Laundering Investigations Unit whenever there are reasonable grounds to believe that a money laundering offence has been or is about to be committed.

- To comply with any directives issued by the Bank of Zambia.

- To designate an officer in each branch or office as the money laundering officer.
- To provide training to staff on anti-money laundering techniques.

In conclusion, Mr Chairman, I would like to state that the effects of money laundering are incomputable and unknown to many of us. The Prohibition and Prevention of Money Laundering Bill has laid a foundation and will serve to deter the use of the Zambian financial system as a site to launder dirty money. It has given each one of us a challenge. For the banking sector, the challenge is to ensure that their corporate governance structures and risk management systems are redesigned to take care of this growing threat.

As for the Bank of Zambia, our challenge is to recognise that technology and globalisation has given money launderers an opportunity to explore new techniques to commit and cover their crimes. This therefore, requires us to be more vigilant, dynamic and resourceful to thwart and overcome the scourge. In addition, full co-operation and coordination within the banking industry in implementing the Bank of Zambia guidelines will go a long way in enhancing co-operation within the region and internationally because money laundering thrives in jurisdictions where there is piece-meal implementation of standards and laws.

Once again, I thank you for inviting me.