Zdeněk Tůma: Challenges of free capital movement and the role of international standards (focusing on money laundering prevention)

Introductory remarks by Mr Zdeněk Tůma, Governor of the Czech National Bank, at the IFex Training Course: Fraud, Terrorist Financing And Money Laundering Prevention, Prague, 15 September 2003.

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Ladies and gentlemen, dear colleagues,

It is my great pleasure and honour to give an opening address to this high-level training course. For my introductory remarks today I have chosen a topic related to the questions you are going to discuss during your seminar. I would like to focus on the issues stemming from free international mobility of capital and on the international standards that have been broadened and deepened in recent years to address underlying challenges. I will also come to the anti-money-laundering standards that form an important part of the new financial architecture.

The last few decades have seen substantial growth in global capital flows. In the emerging market economies alone, the net inflows of foreign capital have now reached about USD 150 billion a year, despite a contraction following the wave of emerging market crises in 1997-1998. The financial flows between the advanced market economies are of an even higher order, of course. Moreover, the turnover in the international markets is substantially higher than the net flows, exceeding global real economic activity many times over. Another striking feature is the fact that the international flows are currently dominated by private capital, which is in sharp contrast to what is has been two or three decades ago when official capital flows used to play a key role.

This trend has been greatly supported by the liberalisation of capital flows, both in the advanced countries and in the emerging markets. The belief has prevailed that in a long run, free movement of capital is welfare enhancing, as it leads to more efficient allocation of capital, faster economic convergence of less developed countries, better consumption smoothing, and diversification of financial portfolios.

Even though these benefits are undisputed, free capital mobility has also created many challenges. On the macroeconomic level, for example, we have observed many currency crises followed by painful stabilisation periods. These crises have often been preceded by periods of fast capital inflows, aggravating vulnerabilities in the domestic financial sectors of the emerging market economies. These financial weaknesses have then functioned as an important transmission channel for macroeconomic shocks, leading to “twin crises”, i.e. a vicious circle of currency depreciations and failures of financial institutions. The Asian crises in 1997-1998 and the recent experience of Argentina are examples of such modern twin crises.

Another challenge related to the massive and liberalised capital flows lies in the area of international fraud and money laundering. The detection of such activities is a crucial preventive policy objective. Money laundering enables criminal activities to grow and cause further damage, the most serious case being terrorist financing. It also leads to potentially high moral and reputational costs for the financial system and for society at large. Finally, it generates inefficiencies and volatility in the allocation of resources, as launderers move their funds not in response to economic rationale, but in an effort to disguise the origin of their money. In the end, this runs counter to the desired benefits of financial liberalisation. However, in an environment where private capital moves quickly from one country to another without any permission being required, seeking the best short-term returns, it is naturally more difficult to detect fraudulent or money-laundering transactions. The environment is also made more challenging by the growing sophistication of financial products in the liberalised and globalised markets and by frequent use of off-shore centres for tax-optimisation purposes.

The ongoing financial innovations and recent negative experience have led to a widespread conviction that the international policy and financial architecture needs to be strengthened. Moreover, it has become widely understood that regulation must be co-ordinated internationally, as tightening it in only some markets and/or countries might merely shift the negative phenomena to other places, without reducing their overall severity. There have been numerous suggestions pointing in this direction, the most ambitious of which include proposals to establish a global lender of last resort and/or a supervisor. So far, however, the actual solution has been the creation of a comprehensive set of international standards and recommendations by international organisations. I consider this approach

to be appropriate, as it fosters the desired degree of international standardisation of the rules, yet leaves enough room to take into account the specific features of each country and its legal system.

In the macroeconomic policy sphere, the key set of international standards for monetary, financial and fiscal policies are embodied in the Code of Good Practices on Transparency in Monetary and Financial Policies and the Code of Good Practices in Fiscal Transparency, approved in 1999 and 2001 respectively. Among other things, these principles deal with the independence of central banks and financial regulators, restrictions on monetary financing of state budgets, greater transparency of policy-making, and data provision. These ideas have indeed had a marked effect in practice, and the first tentative conclusion is that they have helped to mitigate the international contagion of adverse shocks. In the financial regulatory and supervisory area the work to strengthen international standards has also been very intense. The key pillar here is the Basel Core Principles for Effective Banking Supervision, released in 1997. The ongoing work on the Basel Capital Accord, known as Basel II, is a well-known initiative for the future. Transposing all these standards into national legal and regulatory systems has become a key part of the newly founded FSAP, a joint programme of the IMF and the World Bank.

In the anti-money-laundering (AML) area, too, the response to the recent challenges has taken the form of more rigorous international standards. The key standards here are the 40 recommendations of the Financial Action Task Force (FATF), first issued in 1990 and revised twice in 1996 and also this year. After the events in September 2001, eight further recommendations were added, focusing on combating terrorism financing. These recommendations have been accepted by the international financial organisations as a basis for anti-money-laundering criteria in the financial sector. The Basel Committee published a document entitled “Customer Due Diligence for Banks” in October 2001 specifying details of the “know-your-customer” principle for banks. The IMF has added the recommendations to its surveillance work within the FSAP missions and Offshore Financial Centre assessments, having developed a methodology for assessing the general principles in practice. These AML standards are thus on a par with all the other international codes and best practices and form an integral part of the strengthened global financial architecture. I should also note that an increased awareness of the crucial role played by the AML regulations in today’s world is also apparent among private financial institutions themselves. This has been demonstrated, for example, by their adoption of the “Wolfsberg principles” and the involvement of the banking associations in many countries in AML issues.

The AML regulations require financial institutions to identify their customers in certain transactions, either in suspicious ones, or in standard ones such as opening bank accounts, safety boxes, etc. The growing use of modern communications channels, e.g. telephone banking and e-finance, has made it necessary to ensure that the identification requirement is observed equally strictly for these transactions, too. Financial institutions are also obliged to store data that can be used for detecting money laundering and as evidence during subsequent legal action. Special units have been established either at existing regulatory authorities or as new public institutions, to which financial intermediaries are obliged to report either suspicious transactions or transactions exceeding some pre-specified volume. Private financial institutions must create their own internal procedures, including a clear division of responsibilities and staff training, in order to implement all the aforementioned duties in practice. As in the other fields of financial regulation, supervisors are paying increasing attention to examining whether such comprehensive procedures and their control mechanisms have been put in place, are functioning appropriately and are responding to new money-laundering practices and other innovations.

The AML system in the Czech Republic started to be built in 1996 with the adoption of the Act (No 61/1996 Coll.) Concerning Certain Measures against the Legalisation of Proceeds of Criminal Activity (the “AML Act”), which was subsequently amended in 2000. A draft amendment to the AML Act, which implements the EU’s 2nd AML Directive and also the relevant Special Recommendations of the FATF on combating financing of terrorism, has recently been prepared. The Government has approved this amendment and it is currently being debated in the Czech Parliament.

A special Financial Analytical Unit (FAU) has been established as an autonomous part of the Czech Finance Ministry, to which all suspicious transactions must be reported. The regulators of the individual financial market segments, most importantly the Czech National Bank and the Czech Securities Commission, examine the regulated financial institutions’ compliance with the AML Act by means of both off-site and on-site supervision. The home regulators co-operate with the FAU, and also among themselves based on a mutual co-operation agreement. Co-operation with foreign supervisors is being established by signing Memoranda of Understanding. In this respect, the AML activities are

thus following the same trend as the financial supervision in general. A crucial role is, of course, played in the AML system by the law-enforcement authorities, i.e. the police, prosecutors and judges.

In previous years, one of the most sensitive measures in the AML system was the cancellation of the remaining anonymous saving-book accounts, which had a tradition of more than one hundred years in the Czech Republic. This issue, however, has now been resolved, contributing to stricter compliance with international standards in the Czech Republic. I am also pleased to tell you that the most recent progress in this area is the approval of a regulation issued by the Czech National Bank in August 2003 that specifies requirements for banks' internal AML systems. It is based on the BIS's "Customer Due Diligence for Banks". During its lengthy preparation we held numerous consultations with the Czech Banking Association, individual Czech banks, the FAU, further financial regulators and other parties concerned, so as to transpose the international standards into the Czech practice in an optimal way.

The CNB regulation covers all the standard elements of the AML measures I have already mentioned. One of its last paragraphs - but definitely not least - concerns the training of bank staff in AML issues. Given the emphasis on training, let me express the delight that your training course is taking place here in Prague. Given what I have said about the necessity to co-ordinate AML activities internationally, I am also glad to see that those attending the course come from numerous different countries. I hope that you will learn as much as possible here and that you will then have an opportunity to use your new knowledge actively in anti-fraud and AML activities in your home countries. Thank you for your attention.