Patrick Njoroge: The role of banks and the securities markets in curbing the movement of illicit financial flows

Remarks by Dr Patrick Njoroge, Governor of the Central Bank of Kenya, at the 2nd Annual General Meeting and Conference of African Organization of Public Account Committees (AFROPAC), Nairobi, 30 August 2016.

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It is a privilege for me to join this panel to discuss the role of banks and the securities markets in curbing the movement of illicit financial flows. I would like to take this opportunity to thank the African Organization for Public Account Committees (AFROPAC) for inviting me to speak on this topical issue. I would also like to recognize and appreciate AFROPAC's role in promoting transparency and accountability in the governance of public resources.

It is apt to note that the topic of illicit financial flows was recently highlighted at the 14th Session of the United Nations Conference on Trade and Development (UNCTAD) that recently convened in Nairobi about a month ago, a meeting that brought together Heads of States and Governments, and key stakeholders from the business world and civil society.

The damaging effects of illicit financial flows on the African continent are now well-documented and it is only fitting that AFROPAC has brought the issue to the fore.

Stemming illicit financial flows from developing countries has emerged as one of the key issues shaping the global development agenda. As you are aware, Goal No. 16 of the Sustainable Development Goals (SDGs) under the United Nations *2030 Agenda for Sustainable Development*, commits to "significantly reduce illicit financial and arms flows, strengthen the recovery and return of stolen assets and combat all forms of organised crime"[1]. There are good reasons for this:

- ***First, the amounts involved are massive.*** With assistance from the IMF and the World Bank, the advocacy group Global Financial Integrity (GFI) has estimated that Africa loses about US$50 billion annually to illicit financial flows[2]. Additionally, According to the *Report of the High Level Panel on Illicit Financial Flows*, between 1970 and 2008, Africa lost an estimated US$854 billion in illicit financial flows.[3] This amount is equivalent to the development assistance received by the continent over the same period.
- ***Second, illicit financial flows have far-reaching effects****,* particularly on the African continent. These flows and the activities that support them have been shown to lead to increasing inequality in the source countries, in addition to undermining the economic and social institutions, discouraging transparency, and undermining international development cooperation.
- ***Third, all countries are involved in this fight****,* and there are no winners if illicit financial flows are not dealt with.

It is noteworthy that the financial sector is the most common conduit for illicit financial flows. This is largely attributed to the interconnection between national and international financial

[1] United Nations Sustainable Development Goals (September 2015). Available at: https://sustainabledevelopment.un.org/?menu=1300.

[2] Global Financial Integrity (2010) Illicit Financial Flows From Africa Hidden Resource for Development. Available at http://www.gfintegrity.org/storage/gfip/documents/reports/gfi_africareport_web.pdf.

[3] Stop it! Track it! Get it! Report of the High Level Panel on Illicit Financial Flows From Africa (2015). Available at http://www.uneca.org/sites/default/files/PublicationFiles/iff_main_report_26feb_en.pdf.

systems, which can thereby provide a wider geographical reach through which illicit financial assets are moved and laundered. The financial sector, therefore, has to be at the forefront of the agenda to stem illicit financial flows.

Nevertheless, in order to develop and implement policies that would appropriately address the issue of illicit financial flows it is important to appreciate the vulnerabilities of African financial systems. More importantly, to understand how they enable or facilitate the movement of illicit financial flows.

Most of our economies are characterized by the presence of informal financial systems that are primarily cash based. However, significant gains have been made in increasing the level of financial inclusion, most notably in Sub-Saharan Africa, where countries like Kenya and Tanzania have embraced mobile and financial products and services. But the overall level of financial inclusion in Africa remains low. Only a small percentage of the population has bank accounts, and the percentage of those owning insurance policies and securities is even lower. This is relevant given that it serves to hamper efforts to trace illicit financial flows from the continent.

Weak banking regulatory and supervisory frameworks has largely hindered the effective implementation of initiatives aimed at reducing illicit financial flows from Africa. This is reflected at the national level, given that most African countries are yet to fully adopt and implement the 2012 Financial Action Taskforce (FATF) recommendations, the international standards on combating money laundering and the financing of terrorism. The FATF standards are a comprehensive framework of preventive measures that financial institutions are required to implement to address threats to the financial system including illicit financial flows.

Recent assessments of several African countries Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) regimes conducted by the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG), a FATF regional body, revealed that most countries generally exhibit a low level of compliance with preventive measures.[4] The implementation of the customer due diligence, in particular the identification and verification of beneficial owners of corporate entities remains a significant challenge. Closer international cooperation is also needed.

The lack of institutional, technical and human capacity also hampers financial sector regulators' ability to curtail the movement of illicit financial outflows from financial institutions in Africa. The necessary infrastructure that would support regulators efforts to combat illicit financial flows such as Financial Intelligence Units (FIUs), beneficial ownership registries or asset recovery units are either non-existent or in the early stages of development. As a result, the requisite skills required for tracking illicit financial flows, including the ability to profile money laundering risks and analyse suspicious transactions, are severely lacking and in short supply within the continent. New technologies can help but could also facilitate illicit financial flows.

I cannot overemphasise the need for African countries to develop mechanisms that will facilitate transparency. Adoption of mechanisms such as the Kimberley Process for diamonds or the Extractive Industries Transparency Initiative (EITI) would help. In addition, lifting the veil of secrecy and determining who ultimately owns and controls corporate entities that have established business relationships with financial institutions exposes wrong doing and disrupts a key vehicle for illicit financial flows. In this regard, I would therefore urge the continent's legislatures to consider implementing changes to our national laws that would

4 Massa I. (2014) 'Capital Flight and the Financial System' Overseas Development Institute (ODI) Working Paper 413 Available at: https://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/9392.pdf.

enhance our national registries, particularly as relates to the obtaining and sharing of beneficial ownership information.

I would be remiss if I did not mention the Kenyan experience and initiatives that the Central Bank of Kenya(CBK)has adopted in order to foster transparency within the Kenyan financial system. In the past year, CBK has adopted the following measures:

- Stepped up close collaboration with the Financial Reporting Centre (FRC) – Kenya's financial intelligence unit (FIU) – to foster a culture of compliance in the banking sector. Emphasis has been placed on the preventive measures outlined in the Proceeds of Crime and Anti-Money Laundering Act(POCAMLA), Kenya's primary anti-money laundering legislation.
- Provided additional clarity on reporting obligations under POCAMLA including the issuance of guidelines on large transactions in January 2016, intended to provide a clear trail of large cash transactions conducted over the counter in banks.
- Enhanced AML/CFT on-site inspections. CBK is currently developing a risk based AML/CFT supervisory framework with assistance from the International Monetary Fund (IMF).
- Required greater transparency on the part of banks to ensure public confidence. Transparency extends to disclosures by banks on their corporate governance and risk management structures. In this regard, CBK has enhanced the disclosures by banks on their significant shareholders. Banks are now required to disclose on their websites details of significant shareholders who own 5percentor more shareholding.

Let me take the few remaining minutes to share with you some of our key lessons relating to money laundering, particularly with respect to illicit financial flows:

i) Kenya's financial sector is very vulnerable given its strategic position in the region, facilitated by easy access through sea ports, airports and land. Kenya is a fast growing economy with high potential especially in the financial sector. It is therefore attractive to both well-intentioned and ill-intentioned investors.

ii) Inter-agency cooperation between the financial sector regulators, law enforcement agencies and the financial institutions has had a positive effect in stemming illicit financial flows.

iii) The perpetrators of money laundering are very smart and sophisticated, ready to take advantage of any existing loopholes in the law and weaknesses in the internal controls of financial institutions.

iv) Regular interaction with international bodies tasked with the responsibility of preventing money laundering is key in shaping or improving a country's institutional, legal and regulatory framework in combating illicit financial flows.

In conclusion, the battle against illicit financial flows in Africa cannot be won singlehandedly. Governments, legislatures, the judiciary and the private sector must come together. Tackling the underlying sources of illicit financial flows is imperative. For the African financial sector, investment must be made in strengthening preventive measures. Surveillance, detection and recovery procedures must be enhanced. With this comprehensive approach, Africa will be well armed to combat the scourge of illicit financial flows.

I look forward to benefiting from your thoughts and diverse experiences.

Thank you for your attention.