

GRAND COURT LECTURE

CAYMAN ISLANDS

6TH AUGUST 2013

**"THE FATF AND THE INTERNATIONAL COMMUNITY: REVISED
STANDARDS AND NEW CHALLENGES"**

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The views expressed in this lecture are made in a personal capacity and should not be taken to reflect those of any public body or international institution with which I am associated.

THE CONTEXT

It will be recalled that the Financial Action Task Force (FATF) was created at the behest of the Paris summit of the G7 in 1989. It is, primarily, a policy making body and one of limited membership. It is located in but is not formally part of the Paris based OECD. Initially the FATF had a single issue agenda; namely, to set standards and promote implementation of legal, regulatory, and operational measures to combat the laundering of the proceeds of crime. To this end it formulated, in 1990, a package of 40 recommendations. The recommendations had three central themes:

1. To encourage improvements to national criminal justice systems;
2. To strengthen international cooperation; and,
3. To engage the financial sector and other vulnerable businesses and professions in efforts to prevent and detect money laundering (ML).

Over the past 20 years and more the FATF has expanded its membership, deepened its mandate and periodically revisited and amended its standards. It now consists of 34 OECD and strategically important countries plus two regional bodies (EC and GCC). It has also, over time, promoted the establishment of FATF style regional bodies (FSRB's) the members of which are committed to the effective implementation of its recommendations. There are currently eight such regional bodies of which the best known and most firmly established are those for the Caribbean (CFATF) and Europe (Moneyval).

Largely as a consequence, in excess of 180 jurisdictions around the world have endorsed the FATF standards.

As noted, the FATF has also periodically revised and updated its standards in the light of experience. This it did in 1996 and again, but in a more significant fashion, in 2003. Following the 9/11 attacks against the US, the issue of the financing of terrorism (FT) was added to the mandate of the Task Force and nine specific recommendations were formulated to address this new and important issue. In addition to its standard setting work, the FATF and the FATF style regional bodies have also pioneered an innovative and intrusive process known as mutual evaluation through which they monitor, on a country specific basis, both formal compliance with and (increasingly) the effective implementation of its package of recommendations. This is done using a common methodology. The FATF has completed three rounds of evaluation to date.

In the course of the last 18 months the FATF has both completed a further revision of its recommendations and altered significantly the process for the evaluation of compliance with those standards. It is to the nature and extent of those changes that this lecture now turns.

THE REVISED FATF RECOMMENDATIONS

Although the initial proposal for a review to be undertaken, put forward by the UK, Brazil and The Netherlands at the London FATF plenary in the summer of 2008, received a muted (if not frosty) reception it gradually gained political traction and was initiated in the following year. In contrast to previous review exercises, a commendable emphasis was placed on collaboration and inclusiveness. This included the full involvement of the FSRBs and significant outreach to the private sector and other interested parties. The objective was to undertake a limited and focused updating exercise rather than work towards wholesale reform. Nonetheless, the revised standards - adopted on 16 February 2012 - contains a number of changes of both form and substance which are worthy of note.

In so far as the former is concerned, the 9 Special Recommendations on FT have now been fully integrated within the 40 Recommendations. This is intended to reflect both the fact that FT is now a well entrenched concern and the close connections between AML measures and measures to counter the financing of terrorists. In addition there has been a significant expansion of the text of the recommendations and the associated interpretative notes in an effort to bring greater clarity and specificity to the standards. The internal structure or 'batting order' in which the recommendations are presented has also been altered in a major way. The main changes of substance include the following :

1. The Recommendations now contain, for the first time, treatment of the financing of the proliferation of weapons of mass destruction. In particular a new Recommendation (R7) is aimed at ensuring consistent and effective implementation of targeted financial sanctions in this sphere when these are mandated by the UN Security Council;
2. There has been an expansion of the scope of ML predicate offences to embrace tax crimes (related to direct and indirect taxes) and to add a specific tax dimension to the pre-existing obligation in relation to smuggling offences;
3. There has been a strengthening of the AML regime as it relates to corruption especially in the context of the treatment of PEPs [R.12] and in relation to the implementation of the obligations contained in the UN Convention against Corruption;

4. There are enhanced requirements relating to transparency of the ownership and control of legal persons and arrangements [and in the context of the parties to wire transfers]; and,
5. There are more stringent expectations concerning the role of law enforcement agencies and FIUs in the efforts to combat money laundering and FT. This is especially evident in the law enforcement sphere. Here a major emphasis is now placed on the establishment of pro-active financial investigations in all cases related to major proceeds generating offences , not just those in which money laundering conduct is in issue.

However, perhaps the most significant changes agreed to in February 2012 relate to the centrality now afforded to the risk based approach. This is reflected primarily, but by no means exclusively, in the new FATF Recommendation 1 and in its lengthy interpretative note.

As Vladimir Nechaev, the current Russian President of the FATF, stated in July:

“Firstly, this means that countries will have to have effective risk assessment processes in order to identify, assess and understand their money laundering and terrorist finance risks and to ensure that operational, administrative and supervisory resources can be channeled to areas where the risks are higher. Secondly, it means that financial institutions and DNFBPs will have to make money laundering and terrorist financing risk assessments in relation to different categories of customers, products and countries.”

It is true that the relevance and utility of a risk based approach to money laundering were recognized in the 2003 FATF Recommendations. However, what is new is that the understanding of risks and the taking of measures to mitigate those risks have now become, in effect, the fundamental building blocks for national AML systems.

In so far as countries are concerned the new standards, in essence, require – for the first time - that a formal national risk assessment be undertaken. This is a new and exacting challenge for most members of the international community. No set methodology is established for the purpose. However, in February 2013, the FATF produced extensive guidance on options available to jurisdictions in addressing this matter. The World Bank and the IMF are among those international bodies which have gained practical experience in this area and are in a position to offer technical assistance. The limited experience to date indicates that this is a complex and time consuming task.

In addition R.1 requires that countries:

- a) Designate an authority [or mechanism] to co-ordinate actions to assess risk;
- b) Keep the risk assessment up to date; and,
- c) Have a mechanism to produce information on the results to all relevant national competent authorities, financial institutions and other obligated bodies.

Based on this understanding of national risks countries must apply a risk-based approach to allocating resources and implementing measures to prevent or mitigate ML/TF. While countries are afforded great flexibility in how to approach and conduct national risk assessments it must be stressed that the final product will be subject to assessment in the context of the next cycle of mutual evaluations. The common methodology governing that process was finally agreed in February 2013. It emphasises that assessors “should not uncritically accept a country’s risk assessment as correct and need not follow all its conclusions” (para.7). In reviewing it, assessors “should consider the rigour of the processes and procedures employed and the internal consistency of the assessment ---.” They should take “a common-sense approach to whether the results are reasonable.”

It is necessary to stress the importance of securing a favorable assessment of R.1. A deficient national risk assessment finding can have a cascading effect undermining risk-based measures in other recommendations.

EVALUATION OF COMPLIANCE WITH THE FATF STANDARDS

Compliance by individual countries with the revised recommendations of February 2012 will be monitored through a new (4th) cycle of country specific mutual evaluations. These will be conducted, according to an agreed methodology, by the FATF, the FSRB’s, and on occasion by the IMF and the World Bank.

In this area also significant changes have been agreed and are embodied in the new methodology of February 2013. Under the new procedures two, inter-linked, evaluation reports will be produced for each jurisdiction subject to the process.

I. A TECHNICAL COMPLIANCE ASSESSMENT

This will address compliance with the specific requirements of each recommendation. As in the past a rating will be allocated to each recommendation. These will range from ‘compliant’ (C) – (‘there are no shortcomings’) through to ‘non-compliant’ (NC) – (there are ‘major

shortcomings'). Unlike the procedures for the Global Forum on transparency and exchange of information for tax purposes the FATF does not intend to formulate an overall technical compliance rating for assessed countries.

Within the FATF it is anticipated that the compliance assessment will be, in effect, a desk based review which will be undertaken in advance of the on- site visit by the evaluation team.

II. AN EFFECTIVENESS ASSESSMENT

This is the most significant innovation introduced for the 4th round of evaluations and will be the major focus of the evaluation team during its in-country visit. As has been noted elsewhere:

“Assessing effectiveness is based on a fundamentally different approach to assessing technical compliance with the Recommendations. It does not involve checking whether specific requirements are met, or that all elements of a given Recommendation are in place. Instead, it requires a judgement as to whether, or to what extent, defined outcomes are being achieved, i.e. whether the key objectives of an AML/CFT system are being effectively met in practice.”

In this process the attention of the evaluation team is directed to 11 so-called immediate outcomes each of which is said to represent one of the key goals which an effective AML system should achieve. To assist the evaluators the new common methodology sets out, for each of the 11 immediate outcomes, the following:

1. The main relevant features;
2. The core issues to be considered;
3. Examples of the types and sources of information that could support the conclusions on core issues; and,
4. Examples of the specific factors that could support the conclusions on core issues.

This is a highly intrusive process which places a heavy burden on both the assessors and the evaluated country. That said, the methodology explicitly places the onus on the country concerned to demonstrate the effectiveness of its system. In its words:

“if the evidence is not made available, assessors can only conclude that the system is not effective.”

As with the technical assessment, ratings are also allocated in this context i.e. for each of the 11 immediate outcomes. They are:

Effectiveness ratings

High level of effectiveness	Immediate Outcome is achieved to a very large extent. Minor improvements needed.
Substantial level of effectiveness	The Immediate Outcome is achieved to a large extent. Moderate improvements needed.
Moderate level of effectiveness	The Immediate Outcome is achieved to some extent. Major improvements needed.
Low level of effectiveness	The Immediate Outcome is not achieved or is achieved to a negligible extent. Fundamental improvements needed.

No overall effectiveness rating for the jurisdiction is, however, envisaged.

As yet no evaluations using the new procedures have taken place. Within the FATF work will commence in the coming months on Spain and then Norway. The first on-site visits are expected to take place in May 2014 and the Spanish report may well be discussed by governments in a FATF plenary meeting towards the end of next year.

Those initial reports will be of great interest not least in what they reveal about the structure and detail of the reports and, importantly, on the approach taken in practice to the allocation of effectiveness ratings. By that time also it is hoped that the FATF will have clarified the manner in which the outcome of 4th round evaluations will impact on the process of identifying high risk

and non-cooperative jurisdictions- the so-called ICRG process. It is anticipated that there will be further discussion on this very important and sensitive issue at the FATF meeting in October.

CONCLUSIONS

Although the amendments of February 2012 to the FATF Recommendations will have a global impact the challenges posed will differ significantly from jurisdiction to jurisdiction. Some countries, for example, took action in the field of proliferation finance in advance of the FATF changes, others did not. However, it is fair to say that Governments around the world are currently considering their position and action is being taken by many to adjust their laws, practices and procedures in an effort to comply with the new minimum standards in this sphere.

By way of illustration, in my own region preparations for a 4th EU Directive on money laundering and the financing of terrorism are now at an advanced stage. A legislative proposal was published in February and is expected to be adopted later this year or early in 2014. While triggered by the alternations to the FATF standards the opportunity is being taken to go beyond those requirements in certain spheres. For example, it is proposed that the new Directive:

- a) be extended to the whole gambling sector and not just casino operations; and,
- b) that it bring within its scope all persons dealing in goods or providing services for cash payment of EURO 7,500 or more.

At the same time the EU published a proposal to amend the existing Regulation on wire transfers in order to bring it into line with the revised international standards in this area.

In addition, nearly all countries are faced with the challenge of producing for the first time a robust and comprehensive national risk assessment. In *Moneyval* we are urging our members to treat this as a priority. The process is likely to prove to be a complex and demanding one. It is also of importance that there is a sufficient time for the lessons from it to be shared with relevant authorities and the private sector, and for them to take the necessary action to make appropriate changes to their own processes, procedures and assessments. While for many countries the next round of mutual evaluations using the new methodology may be some time off, it is also important that early consideration is given to the implications which flow from the new emphasis on effectiveness. It will take time to identify areas of weakness, to put in place changes designed to improve performance, and for such improvements to manifest themselves in practice. The stakes for all countries remain high. The need for a continued focus on these issues is, I trust, clear.

Finally, it is inevitable, given the nature, scope and intrusiveness of these international standards, that practical implementation will, on occasion, give rise to controversies which will need to be resolved by the courts. In the past issues related to the FATF Recommendations in such areas as targeted financial sanctions and the imposition of AML obligations on the legal profession have come before the judiciary at both the national and international levels (including the Grand Chamber of the Court of Justice of the EU and the European Court of Human Rights). This is, in short, an issue which affects us all.
