

Preventing the financing of illegal activities outside the EU by European financial institutions

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Summary

Financing of illegal activities

In the past two decades, banks, insurance companies, and other financial institutions have grown into globally operating financial services conglomerates. With their office network and clientele now spanning the globe, financial institutions based in the European Union increasingly deal with companies and organizations which are active in countries with weaker law enforcement capabilities. Inevitably, they run a greater risk of financing clients involved in illegal activities with negative sustainability impacts. These activities may include:

1. Polluting air, water or soil beyond the limits and areas regulated by environmental permits or other regulations
2. Logging, mining, hunting, fishing or other forms of exploiting natural resources outside concession areas, in excess of legally permitted quantities or by non-permitted methods
3. Killing species which are protected in any way
4. Deforestation or other forms of habitat destruction for agriculture or aquaculture outside concession areas or by non-permitted methods
5. Occupying land owned by indigenous or other local communities to undertake industrial or agricultural activities, also when this ownership is grounded merely in custom law
6. Contravening labour laws, regulations and international conventions with regard to working hours, remuneration, working conditions, child labour, etc.

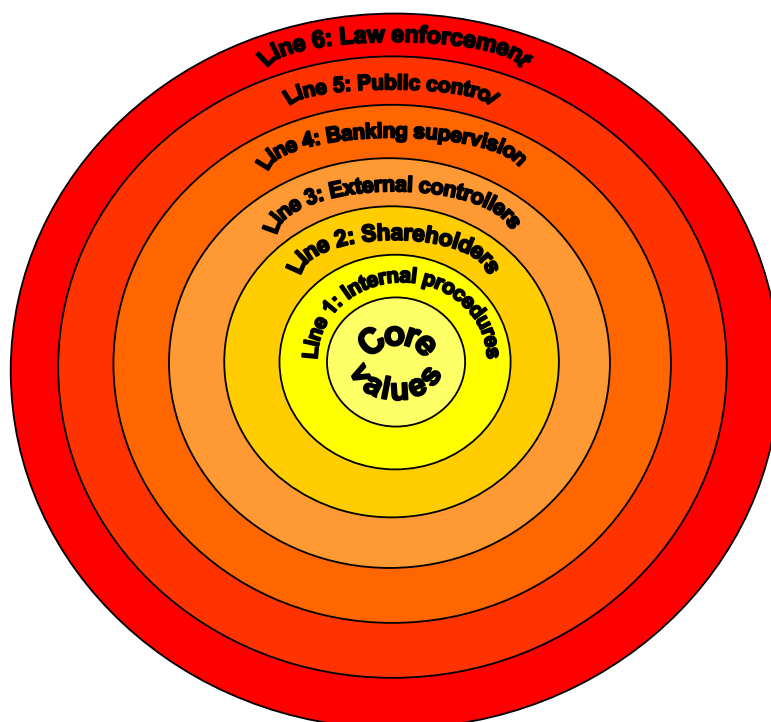
The European Union and its member states cannot rely on foreign governments and financial institutions to prevent such practices. In February 2002 the European Union, in line with the *Rio Declaration*, acknowledged its responsibility in ensuring that globalization goes hand in hand with environmental management and combating poverty and crime (European Commission communication *Towards a global partnership for sustainable development*). The European Union and its member states, therefore, should endeavour to prevent the financing of illegal corporate activities outside the European Union by financial institutions based in the EU. However, it is not clear how the EU and its member states can pursue this goal.

Six Lines of Defence Model

The objective of this study is to explore which policy options are available to the EU and to the governments of its member states to prevent the financing of illegal activities. In our view, governments and regulatory authorities do not have to approach this issue as their exclusive responsibility. By applying a range of intelligent policy options, the government could stimulate and enable other stakeholders – such as shareholders, external controllers, NGOs and the general public – to play a stronger role in helping financial institutions to prevent the financing of illegal corporate activities outside the European Union.

To categorize and evaluate all the various policy options we have developed the *Six Lines of Defence Model*. These defend the *Core Values* society expects financial institutions to uphold. These *Core Values* define the socially responsible financial services and the operational activities of financial institutions that promote sustainable development. In other words: desirable and permitted financial services and activities. The *Six Lines of Defence* protecting these *Core Values* each involve a different group of actors. The *Six Lines of Defence* and the relevant actors are:

1. Internal (control) procedures inside the financial institution: employees, management, board members and/or credit committees
2. Shareholders
3. External control: financial and environmental auditors, corporate lawyers, credit rating agencies and financial analysts
4. Banking supervisors and other supervisory authorities for the financial sector
5. Public control: groups affected by the activities, NGOs, trade unions, researchers and media
6. Law enforcement: criminal prosecution by judicial authorities as well as civil law suits



The Six Lines of Defence Model

This study identifies policy options which the European Union and its member state governments can use to strengthen the *Six Lines of Defence*, for example by providing other stakeholders with the means and the opportunities to strengthen their own *Line of Defence*, or by assigning them new responsibilities.

To identify effective policy options we examined a large number of policy initiatives launched by international organizations, the main ones being the United Nations, the Basle Committee on Banking Supervision, the Financial Action Task Force on Money Laundering and the European Union.

United Nations

The report of the *World Commission on Environment and Development* (1987), the *United Nations Conference for Environment and Development* in Rio de Janeiro (1992) and the *World Summit on Sustainable Development* in Johannesburg (2002) were important in shaping the definition of sustainability. Financial institutions also have a role to play in sustainable development and the *Johannesburg Plan of Implementation* asks governments to 'encourage financial institutions to incorporate sustainable development considerations into their decision-making processes'.

In May 1992, in the run up to the UNCED conference in Rio, the United Nations Environment Programme (UNEP) launched a Banking Initiative. This was later expanded to become the *Finance Initiative*, which brings together financial institutions committed to sustainability. The signatories to the *UNEP FI Statement* commit themselves, among other things, to comply with 'local, national, and international environmental regulations applicable to our operations and business services' and to 'work towards integrating environmental considerations into our operations, asset management, and other business decisions, in all markets'. Signatories regularly exchange information on how they aim to achieve this and other goals, but their efforts to date have not been fully transparent.

Other important initiatives by the UN are the *Århus Convention*, which grants NGOs access to information, public participation and access to justice regarding environmental issues, and could also be applied to the regulation of sustainability issues in the financial sector, the *UN Global Compact*, which sets ten basic rules for corporations, the *ILO Multinational Enterprises Principles*, which contain specific rules on labour issues, and the *UN Human Rights Norms for Business*.

Basel Committee on Banking Supervision

The most important international organization in the banking world is the Basle Committee on Banking Supervision (BCBS), a forum for regular cooperation on banking supervisory matters between its thirteen member countries. The recommendations of the BCBS underpin banking regulations in most countries of the world. In particular, the 1988 *Basle Capital Accord* established criteria for minimum capital requirements for banking organizations and has been adopted by almost every country in the world. In June 2004 the BCBS agreed on the second *Basle Capital Accord*, which prescribes a more sophisticated approach to risk management and the adequate capitalization of banks. Governments transposing the BCA-II into national legislation have various options for emphasizing the management of sustainability risks by banks. A key task is setting criteria for defining their capability to research social and environmental issues for credit rating agencies, which are assigned a crucial role in the BCA II.

The BCBS has also issued a large number of other publications and recommendations, covering various fields of banking regulation. Important among these are the various publications on cooperation between banking supervisors on cross-border banking issues, extensive 'Know Your Customer' regulations which oblige financial institutions to investigate the identity and activities of its customers, and disclosure regulations.

Financial Action Task Force on Money Laundering

The Financial Action Task Force on Money Laundering (FATF) develops and promotes policies, both at the national and international levels, to combat money laundering and terrorist financing. In 1990 the FATF issued the *Forty Recommendations on Money Laundering*, which were last revised in 2003. After 11 September 2001 this publication was complemented by the *Eight Special Recommendations on Terrorist Financing*.

The most recent version of the *Forty Recommendations* broadens the crime of money laundering to cover all serious offences, including environmental crime. It suggests a number of concrete internal policies, procedures and controls that financial institutions can apply to avoid providing financial services to clients involved in illegal activities. The *Forty Recommendations* also prescribe a large number of measures regulatory authorities should undertake to ensure that financial institutions comply with the proposed measures.

If transposed into national law, the *Forty Recommendations* could be very effective in preventing the financing of illegal corporate activities outside the European Union. Although most attention in the money laundering discussion is focused on financial services such as deposits, money transfers and similar services, many more financial services (offering credits, loans, etc.) can be used for money laundering. A more explicit definition of the various financial services that could potentially be used for money laundering would provide more guidance to financial institutions and supervisory authorities.

European Union

Many of the initiatives taken by UN bodies, the BCBS and the FATF have already been translated by the European Union into directives, which must be transposed into national legislation by the member states. The effectiveness of this legislation in preventing the financing of illegal corporate activities outside the European Union could be improved by taking the remarks made above into account.

Apart from these EU directives originating from international developments, many more EU directives and policy initiatives adopted and discussed in recent years could be relevant to the subject of our study. An important group of directives, derived from the 1999 *Financial Services Action Plan* (FSAP), are designed to implement the liberalization and harmonization of the financial markets of the European Union. Among these are the *Prospectus and Transparency Directives* (which improve the transparency of the activities of clients of financial institutions on their business activities), new *Accounting Directives* (which require reporting on environmental liabilities), the *Occupational Retirement Provision Directive* (which allows member states to set stricter rules for the investment policies of pension funds) and the *Investment Services and Market Abuse Directives* (which set rules for financial analysts).

In 2002 the European Union adopted the *Lamfalussy-approach* to speed up the decision-making process surrounding the FSAP. Under this approach the financial services directives, including the *Capital Adequacy Directive* and the *Money Laundering Directive*, have the structure of framework legislation which can be elaborated by more detailed implementation measures, definitions, guidelines, standards or interpretation recommendations. For banking directives, these measures may be issued by the *European Banking Committee*, which consists of representatives from the member states, and the *Committee of European Banking Supervisors*, which is composed of national supervisory authorities. Similar committees exist for regulations regarding other types of financial institutions. The *Lamfalussy-approach*, therefore, offers excellent opportunities to tailor existing directives to prevent the financing of illegal corporate activities outside the European Union, thus bypassing the long and difficult procedures for drafting and adopting new directives.

The European Union has also recently launched a number of initiatives to strengthen the position of shareholders (the *Action Plan on Company Law and Corporate Governance* and the *Strategy to Prevent Financial and Corporate Malpractice*), to stimulate corporate social responsibility among European corporations and financial institutions, and to develop a policy on credit rating agencies. If more emphasis is put on preventing the financing of illegal

corporate activities outside the European Union, all these initiatives could result in effective directives and implementation measures.

Another EU policy field relevant to the subject of our study is environmental and sustainable development policy. The *European Union Sustainable Development Strategy* (February 2002) acknowledged the EU's responsibility for ensuring that globalization goes hand in hand with environmental management and combating poverty and crime. The EU sees a role in this for the financial sector and aims to develop 'a voluntary initiative with the financial sector, covering guidelines for the incorporation of data on environmental cost in company annual financial reports, and the exchange of best policy practices between Member States'. A more concrete, sector-based follow-up to the Strategy is the *EU Action Plan for Forest Law Enforcement, Governance and Trade (FLEGT)*, which states that 'banks and financial institutions investing in forest sector operations should be encouraged to assess the risk attached to the social and environmental factors which could have a bearing on the viability of their investments'.

Two environmental directives which could have resulted in effective instruments to prevent the financing of illegal corporate activities outside the European Union have failed to live up to this promise. The *Protection of the Environment through Criminal Law Directive*, which could have expanded the number of environmental crimes to which the *Money Laundering Directive* applies, has been stalled because of differences in opinion between the European Commission and the European Council. The *Environmental Liability Directive* was adopted in 2004, but a strong financial sector lobby succeeded in keeping the issue of lender liability outside the directive, except for cases where the financial institution 'operates or controls the occupational activity' or has 'decisive economic power over the technical functioning' of the activity of its client.

Other international organizations

A large number of other international organizations have issued statements, publications and suggestions relevant to the subject of our study. The *Collevocchio Declaration* by the BankTrack NGO network defines what society expects of the financial sector. The *Equator Principles*, the *London Principles of Sustainable Finance*, the *Wolfsberg Anti-Money Laundering Principles* and the *WBCSD Financial Sector project* define voluntary investment standards for the financial sector. The *Global Reporting Initiative* and suggestions made by BankTrack regarding the *Equator Principles* indicate how financial institutions could improve the transparency of their financing and investment policies. The *OECD Guidelines for Multinational Corporations* introduce an interesting model for a public complaint and accountability mechanism which could be applied to the financial sector as well.

Country case study: Netherlands

Although the international developments described above are increasingly important in shaping the legal and regulatory frameworks in the EU member states, national differences will continue to exist for historical reasons and because of political differences. Knowledge of national legal and regulatory frameworks is necessary to explore the policy options available to national governments and authorities. As an example we examined the legal and regulatory framework existing in the Netherlands and came to the following conclusions:

1. Both the Dutch financial sector regulations and the more general anti-money-laundering regulations implicitly aim to prevent the provision of financial services to clients undertaking illegal activities (inside or outside Europe).
2. Apparently neither the financial institutions themselves, nor the supervising authorities and policy makers, seem to be aware of the obligations on financial institutions under these regulations to prevent the provision of financial services to

clients undertaking illegal activities (inside or outside Europe). Greater awareness of this obligation and appropriate actions are needed to strengthen the *Core Values*, the *Fourth Line of Defence* (financial supervision) and the *Sixth Line of Defence* (law enforcement).

3. The most obvious policy option is to strengthen the *First Line of Defence* (internal procedures) by demanding more extensive customer due diligence by financial institutions. Financial institutions should make more effort to uncover the actual activities of their clients, including those demanding loans and credits. To do this in a cost-effective way, certain categories of clients should be defined for which this extensive customer due diligence is mandatory.
4. A full list of policy options to strengthen the *Six Lines of Defence* is given in the table below.

Policy options

Drawing on our investigation of international initiatives and the Netherlands case study, we have identified 18 policy options linked to the *Core Values* and each of the *Six Lines of Defence*. These 18 policy options can be implemented in the national legislation or regulatory guidelines of the member states and via implementation measures and interpretive guidelines at the EU level (following the *Lamfalussy-approach*).

As policymakers will probably not be able to take up all these 18 policy options simultaneously, we have tentatively ranked their effectiveness in furthering the goal of preventing financial institutions from providing financial services to clients involved in illegal activities with negative sustainability impacts outside Europe. The results of this ranking (on a scale of 1 to 5) are summarized in the following table, which lists the policy options applicable to the *Core Values* and each of the *Six Lines of Defence*.

	Policy options	Score
Core Values	Encourage financial institutions to adopt broader mission statements	2
1	Demand strong internal procedures in the operating licence	4
2.1	Enhance the transparency of financial institutions	3
2.2	Connect shareholder rights with shareholder responsibilities	1
3.1	Increase client transparency	2
3.2	Improve the analysis of (potential) clients	3
4.1	Strengthen cross-border supervision	2
4.2	Broaden control on customer due diligence procedures	4
4.3	Set stricter rules for the investment policies of pension funds	4
4.4	Designate environmental crimes as money laundering crimes	3
4.5	Sharpen the definition of financial services related to money laundering	4
5.1	Enhance the transparency of regulators	2
5.2	Introduce public complaint and accountability mechanisms	3
5.3	Strengthen NGO capacities	3
5.4	Introduce lender liability legislation	4
6.1	Introduce effective money laundering sanctions	3
6.2	Training and equipping law enforcement authorities and Financial Intelligence Units	4
6.3	Increase mutual legal assistance and extradition	2

As shown in this table, we estimate that the effectiveness of these 18 policy options will vary strongly, although each policy option would contribute to some extent to achieving the goal. Further, we would not advise policy makers to concentrate solely on one or two of the most effective policy options. Based on the *Six Lines of Defence Model*, we believe that it would be sensible to strengthen all *Six Lines of Defence* together, as this would involve as many relevant stakeholders as possible. In turn, this would increase social support for each individual policy option, reinforcing the effectiveness of each option. We therefore recommend implementing at least one policy option for each *Line of Defence*.

We have to stress, however, that the ranking of policy options is still provisional. Many of the policy options should be worked up in more detail and their effectiveness and feasibility evaluated more profoundly. These elaborations and evaluations could be structured in a follow-up project.