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# FUGA DE CAPITAIS

**E a política de desenvolvimento a  
favor dos mais pobres em Angola**



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# Capital flight from Africa - with a little help from the banks\*

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## Summary

Africa is a source of large-scale capital flight. The purpose of this paper is to shed light on how banks facilitate capital flight from Africa. There is growing evidence that subsidiaries of the world's major banks have been heavily involved in facilitating capital flight and money laundering. Banks and financial institutions therefore are an important piece of the puzzle to better understand the drivers of capital flight from Africa. Banks are also an important component in the development of more effective measures to curb the problem. The paper argues that to improve the regulation of the banking and finance sectors, there is a need for more detailed knowledge on how banks actually operate as facilitators and the mechanisms applied.

**Keywords:** Capital flight, illicit capital flows, international finance, banking sector, Africa

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# 1 Introduction

A major constraint to economic growth and development in Africa is the shortage of financing. The large financing gaps deter public investments and social service delivery. At the same time, Africa is a source of large-scale capital flight (AfDB and GFI 2013; Boyce and Ndikumana 2012; Ndikumana and Boyce 2011). According to Kar and Cartwright-Smith (2010), illicit financial flows out of Africa over the period 1970 to 2008 may be as high as US\$1.8 billion. These outflows from Africa exceed the amount of official development assistance and foreign direct investment received during this period. Massive capital flight has turned Sub-Saharan Africa into a ‘net creditor’ to the rest of the world (Ndikumana and Boyce 2008). Some of the capital outflow ends up in private accounts at the same banks that made loans to African governments. The ‘know your customer’ principle of banks has not managed to stop politically exposed persons (PEPs) from stealing public funds and to storing the stolen assets in private accounts abroad.

The sources of capital flight from Africa differ between countries. In natural resource-rich countries, the resource sector is the main source of illicit financial flows (Ndikumana and Boyce 2011). For instance, according to the International Monetary Fund (IMF), about USD 4 billion from oil sales in Angola in 2002 alone, was not reported in the national accounts (AfDB & GFI 2013: 45). Commonly, rents and royalties derived from resource management are embezzled or expended in unproductive ways through corruption and elite capture. In resource-poor countries, illicit financial flows often originate from the mispricing of trade by companies of all sizes (ibid. 47). While trade mispricing mainly involves money laundering and tax evasion by corporate actors, government imports and exports often are manipulated by corrupt officials demanding bribes or kickbacks.

Ndikumana and Boyce (2011) find that a substantial share of the capital flight from Africa has been public loans that are channelled out of the country as private funds. A ‘revolving door’ relationship has been identified between debt and capital flight. In some cases as much as 80 percent of the public loans have left the country as private assets through capital flight (Ajayi and Khan 2000; Boyce and Ndikumana 2001; Cerra *et al.* 2008; Ndikumana and Boyce 1998, 2003). Consequently, the assets are in the hands of private Africans, while the liabilities are public, owed by the African people at large through their governments.

Banks and financial institutions are an important piece of the puzzle to better understand the drivers of capital flight from Africa. Banks are also an important component for designing measures to curb the problem. In the foreword to a book published in 2011 on the global financial system and ethics, Daniel Lebègue, former director of the French Public Treasury wrote (ICIJ & CPI 2013: 112): “*Banks are expected to behave in a socially responsible manner and to keep a close eye on the impact of their activities (...) Governments and professionals are jointly responsible for ensuring that the globalization of trade does not go hand in hand with an exponential increase in fraud and financial crime including money laundering, corruption and tax havens.*” The actual behavior of the banking sector has proved to be far from this ideal. Although governments and the banking industry have made efforts in recent years to implement regulations and procedures to counter the laundering of the proceeds of crime, the actions to combat tax evasion and fraud have proved to be insufficient (Gilmore 2011). There is growing evidence that subsidiaries of the world’s major banks have been heavily involved in facilitating capital flight and money laundering (Palan *et al.* 2010;

Reuter 2012; US Senate Permanent Subcommittee on Investigations 2012; ICIJ & CPI 2013). Thus, banks should not be disregarded as passive players when analysing capital flight.

Current literature addresses some of the challenges with respect to illicit financial flows from African countries, including developmental impacts and the role of offshore financial centres. Knowledge about the role of onshore banks, however, is in short supply. Further, literature on the banking sector in Africa rarely refers to the banks' role in capital flight. This paper is a first step in the development of more in-depth knowledge on how banks facilitate capital flight from Africa. The study addresses the following questions:

- What role do banks play in capital flight from Africa?
- What are the most common methods for banks to channel illicit financial flows?
- What policies are imposed to regulate the bank and finance sectors and what is the relevance of these policies for African countries?

The paper is structured as follows: The following section 2 clarifies how capital flight and the banking sector are defined. Section 3 provides an overview of the role banks play in capital flight from Africa. Common methods applied for channeling illicit financial flows through banks are examined in Section 4. Section 5 discusses strengths and weaknesses of policies imposed to regulate the bank and finance sectors. Finally, Section 6 concludes.

Annex 1 gives a brief introduction to the new U.S. *Foreign Account Tax Compliance Act* (FATCA). This is the most wide reaching initiative so far to target bank secrecy that facilitates non-compliance by taxpayers using foreign accounts.

## 2 Defining capital flight and banking

The term *capital flight* does not have one universally accepted and precise definition. Actors who aim to reduce or stop capital flight from developing countries thus have a challenge. What exactly are they addressing? In this review we will follow the definition by Kapoor (2007: 6-7) of capital flight as “*unrecorded and (mostly) untaxed illicit leakage of capital and resources out of country*”. His understanding opens up for an analysis of how capital flight potentially impacts on development. The characteristics of capital flight according to the above definition are that the resources are domestic wealth that is permanently put out of reach for domestic authorities. Much of the value is unrecorded and attempts to hide the origin, destination and true ownership of the capital are parts of the concept.

The concept ‘capital flight’ can also describe processes beyond what is defined above. Other perspectives are to view capital flight as (a) sudden short-term capital outflows, including both licit and illicit flows, or (b) the stock of wealth, both licitly and illicitly acquired, held abroad by the citizens of a developing country (Epstein 2005: 58-65). In this paper we will not take into account the licit financial flows from developing countries. We will, however, apply a sufficiently wide definition to include most channels of illicit flows from poor countries (Kapoor 2007: 6-9).

Illicit financial flows involve the expatriation of money earned through tax evasion, abusive transfer pricing by multinational corporations, corruption, criminal activities etc. Similarly, legal funds earned through legal business, but transferred abroad in violation of exchange

control regulations also become illicit (AfDB & GFI 2013).<sup>1</sup> However, the distinction between what should be defined as illicit and what can pass for licit flows are not always clear. On the one hand a lawyer will categorise what is not illegal as legal. A lawyer can thus perceive the grey zones as their area of creating a business, because they are in a special position to advise clients on how to use the loopholes and grey zones for the best interest of the client. On the other hand, grey zones can be perceived as potentially dodgy, because there is space for immoral behaviour that does not necessarily care for the original intention of the laws.

Banks are in this study referred to as financial institutions that are licensed by the government. The financial services offered may vary from country to country, but managing bank accounts are seen as one of the most indispensable services of a bank. There are several methods of transferring values that do not involve a bank transfer, including ‘cyberpayment’ technologies and systems which use the internet as a means of transfer of electronic money or ‘digital money’ (Gilmore 2011: 46-7). However, non-banks that provide payment services such as remittance companies offer a narrow set of services and are therefore rarely considered to be a proficient substitute for banks. Banks and other financial service providers are rather seen to complement each other. Flows of money channelled through various institutions are expected to end up in the banking system at some point. It is therefore important to focus specifically on the role of banks in facilitating capital flight. Masciandro (2007:27), however, claims that the development of the architecture of markets and the characteristics of intermediaries have blurred the difference between banking and non-banking firms.

The jurisdiction which the bank operates within lays out conditions for what kind of services a bank can offer.<sup>2</sup> Varying levels of customer confidentiality are the most important difference between banks which are pointed out in the literature. *Offshore banks*, *secrecy jurisdictions* and *tax havens* are the most common concepts used to describe the extraordinary confidentiality conditions that are found within certain jurisdictions, such as the British Virgin Islands, Cayman Island and Mauritius. A commonly accepted definition is not in place to describe and categorise jurisdictions with different financial services combined with secrecy rules and tax benefits. Therefore, no conclusive list exists of countries with a banking sector that are specifically attractive for transfers of illicit capital (NOU 2009).

‘Secrecy jurisdiction’ is probably the most precise concept since it points to the legal space which the banks operate within. This term has a better explanatory value to the phenomenon of regulatory vacuums created by secrecy jurisdictions than alternative expressions.<sup>3</sup> A

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<sup>1</sup> The concept of illicit financial flows differs from the concept of capital flight. The African Development Bank provides the following clarification (AfDB & GFI 2013: 21): “...the term ‘capital flight’ largely puts the emphasis on the ‘push’ factors in developing countries. Illicit financial flows consider both the push factors in developing countries as well as the ‘pull’ factors in developed countries.”

<sup>2</sup> A jurisdiction refers to the geographical area within which authority and powers have been granted to the executive and legislative branches. This may be a state, dependency, protectorate, sub-national state, principality or other that has the ability to create law.

<sup>3</sup> In the literature, ‘offshore banking’ and ‘tax havens’ are commonly used. However, these two concepts are imprecise. The term ‘offshore’ gives an incorrect impression about a specific geographical location offshore. The Financial Secrecy Index shows that many of the least transparent places are onshore in OECD-countries, including Switzerland, United Kingdom and USA (TJN 2011). The secrecy space that is created due to lack of transparency can be regarded as a non-geographical space. Thus, ‘offshore’ is a misleading concept. The term ‘tax haven’ may give an impression that tax avoidance is the only purpose, while other financial services often are equally important. Palan *et al.* (2010), NOU (2009) and Murphy (2008) provide good overviews of the discussion on definitions and concepts.

secrecy jurisdiction has two main characteristics: a) part of its financial regulations is primarily designed to benefit people who are not residents in its territorial domain; and b) legislation exists that prevent the identification of those who use its regulations and are residents outside the jurisdiction (Murphy 2008). Thus, main features of these jurisdictions are high levels of secrecy and the ease with which companies and other legal entities, including trusts, can be established and registered (Palan *et al.* 2010).

The *secrecy space* that is formed by these jurisdictions can be referred to as the unregulated spaces or regulatory vacuums for economic transactions that are created by the services offered. Banks, lawyers, accountants, trust companies and others who assist customers to access the services offered by secrecy jurisdictions are *secrecy providers*. The concept *secrecy world* can be used to describe the combination of secrecy space and providers (Murphy 2008: 28).

### 3 The role of banks in capital flight

The banking sector features both as a facilitator of capital flight and as a possible instrument to curb the problem, including asset recovery. The role of banks in capital flight can be categorised in four main thematic areas:

- 1) Money laundering.
- 2) Secrecy jurisdictions and calls for transparency.
- 3) Customer due diligence and banking in developing countries.
- 4) Asset recovery.

In the following sections each of these thematic areas are examined.

#### 3.1 Money laundering

Money laundering is often connected with tax evasion, corruption or terrorist financing (UNODC 2007; OECD 2009; Chaikin and Sharman 2009). Money laundering commonly requires three major steps (UNODC 1998; Chêne 2009; Gilmore 2011). First is the placement where the money is entering the legitimate financial system. Second is the layering where the money is moved through the international financial system. Third, the money is integrated into the legitimate economy when its origin is disguised. Banks can in practice be involved in all three steps in various ways, but not necessarily in such a way that bank personnel would be able to trace the origin of the money or the actual owner.<sup>4</sup>

The actions of bank officials often depend on the type of customer and the suspected origin of the funds. Investigations show that there is a major challenge for banks to avoid tainted funds from politically exposed persons (PEPs). Many cases have been revealed in recent years where banks are used to channel illicit funds acquired by politically powerful persons out of the country of residence and into secret, private accounts (Palmer 2009). Examples from Africa have involved former president Sani Abacha in Nigeria, president Teodoro Obiang in Equatorial Guinea and the late president Omar Bongo in Gabon (Daniel *et al.* 2008/09; US

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<sup>4</sup> Goredema (2004a, 2004b) provide insightful overviews of the capacity to tackling money laundering in East and Southern Africa. Other relevant studies of money laundering in Africa include a study of Mauritius (IMF 2008), and reports from the Eastern and Southern Money Laundering Group (ESAAMLG 2009a, 2009b; FATF and ESAAMLG 2009; Goredema and Madzima 2009).

Senate Permanent Subcommittee on Investigations 1999; Jimu 2009; Pieth 2008; Global Witness 2009b).

The US Senate Permanent Subcommittee on Investigations found that banks aggressively marketed methods for hiding money from national tax authorities. For instance, bankers from UBS, Switzerland's largest bank, travelled to the US in search of wealthy individuals and proactively promoted their services to these (US Senate Permanent Subcommittee on Investigations 2003, 2006, 2008). In 2009 the U.S. Department of Justice successfully brought a criminal case against UBS for assisting offshore tax evasion, forcing the Swiss bank to pay US\$780 million to settle allegations that it had helped Americans dodge taxes (ICIJ and GFI 2013). This was followed by actions against a dozen other Swiss banks.

It is likely that the practices revealed in the US have been common in other countries too, also in Africa. Private banking units of the world's largest banks, including UBS, HSBC, Barclays, Clariden and Deutsche Bank, use secrecy jurisdictions to serve their "high net worth" clients and solicit deposits from customers across national borders. For instance, a recent study by the US Senate Permanent Subcommittee on Investigations (2012) found that the large, global bank HSBC has very poor routines against money laundering.<sup>5</sup> The US Senate Committee documents a number of cases where HSBC has facilitated money laundering by opening a large number of accounts for so called 'high risk' clients. James S. Henry, former chief economist at the international consulting firm McKinsey & Company, claims that giant private banking units seek to "entice the elites of rich and poor countries alike to shelter their wealth tax-free offshore, usually in contravention of these home countries' laws" (ICIJ and GFI 2013: 107).

Channeling funds to terrorist activities often take place via formal finance institutions. However, informal financial networks are commonly also involved. These are systems where formal rules and regulations are not guaranteed to be followed (Passas 2003, 2006). Underground (hawala) banking are used for legal transfers between countries and other purposes than terrorist funding, but it is mainly in the literature on terrorist funding that the issue is raised. Due diligence practices and registers of transfers do not necessarily exist in informal banking (Baker 2005; McCusker 2005).

Anti-money laundering regulations are in place in most African countries. However, the effectiveness of the regulations can be questioned. Moshi (2007) emphasises that there are some structures that are unique and common for African countries. He argues that these have to be accounted for in anti-money laundering and combating the financing of terrorism measures. He criticises the global initiative of FATF<sup>6</sup> and other financial standards for not providing practical and realistic methods for how to prevent and detect money laundering and terrorist financing in the African context. According to Moshi (2007:7), the standards do not sufficiently recognise that African economies are (a) largely cash based, (b) there is a heavy reliance on a parallel, informal banking system, and (c) informal value transfer methods are the norm. Others, including Christensen (2009:7), argue against those claiming that money laundering is a structural problem and blame instead lack of political will.

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<sup>5</sup> HSBC (Hong Kong and Shanghai Banking Corporation) with head office in London has around 300,000 employees; 7,200 subsidiaries/offices around the world in more than 80 countries; 89 million clients; and a turnover of USD 22 billion in 2011 (US Permanent Subcommittee on Investigations 2012).

<sup>6</sup> The Financial Action Task Force (FATF) is an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing that has made two sets of AML/CFT recommendations that are internationally acknowledged.

### 3.2 Secrecy jurisdictions and calls for transparency

Banks in secrecy jurisdictions have been found to play an important role in facilitating the hiding or laundering of capital from Africa because of the secrecy space that exists for financial activities and banking (Kapoor 2007; Murphy 2008; Palan *et al.* 2010). It is argued that more transparency in the financial sector in these jurisdictions is required to give businesses, criminals and politically exposed persons (PEPs), such as high-level politicians and associates, fewer ways to hide their illegally gained capital. For developing countries more transparency and fewer hiding places could mean that less public funds would be channelled out of the country as private assets. This would make more resources available for service provision and poverty reduction measures (Christian Aid 2008; Task Force on Financial Integrity and Economic Development 2009a, 2009b).

Although there is a wide literature promoting transparency and documenting the negative consequences of secrecy banking, the literature is not exclusively portraying secrecy jurisdictions negatively. There is general agreement of the need to countering money laundering and the financing of terrorism, but the views on how to do so differ. On the one side are those promoting transparency who argue in favour of country-by-country reporting and global agreements to end banking secrecy (Christensen 2009; NoU, 2009; Palan *et al.* 2010). On the other side are trade organisations, business associations, investment funds and lawyers who argue that the picture portrayed of secrecy jurisdictions is highly skewed, and that these jurisdictions are professional, well-functioning finance centres with important functions for legitimate businesses. Positive features include political and economic stability, standardisation of language, a tailored legal framework and that double taxation of international operations are easier to avoid. The legal part of banking activities in secrecy jurisdictions is argued to be largely overlooked in much of the literature criticising these types of financial structures. To close down banking operations in secrecy jurisdictions therefore are not a desired alternative for all (Antoine 2002; NHO 2009). In the book *'Capitalism's Achilles heel. Dirty money and how to renew the free-market system'* Raymond Baker (2005) criticises the views that support the secrecy structures and argues that they are fundamentally flawed. He dismisses the possibility of being able to “*successfully protect ourselves from a narrow range of dirty money we think hurts us, while at the same time cultivating a much broader range of dirty money that we think help us*” (Baker 2005:190). However, full transparency is not necessarily what is requested. OECD (2010:14) states that some banking secrecy must be accepted, but that it is the possibility of lifting the secrecy in well-defined circumstances to enable countries to enforce their own laws that are required.

As a consequence of the crisis that struck the global financial system in 2007/08, secrecy jurisdictions have come into public scrutiny for providing tools for tax evasion, money laundering and terrorist funding. In the report *'The morning after the night before. The impact of the financial crisis on the developing world'* Christian Aid (2008) explains how lack of transparency in financial centres and banking secrecy contributed to create turmoil in the global financial market. Earlier publications also point to the damaging effects of banking secrecy, but the financial crisis has given a new urgency to the topic (Leaders of the G20 2009; Global Witness *et al.* 2009). OECD (2010:2) describes the topic of tax evasion and secrecy jurisdictions as *'very high on the political agenda'*.

The media have followed up the focus on secrecy jurisdictions. Newspaper articles such as the New York Times *'A Swiss bank is set to open its secret files'* (Browning 2009) report a change in the secrecy rules of some jurisdictions. Christian Aid (2008:12) went as far as to claim that most of the shadow banking sector had disappeared after the financial crisis since



banks were not willing to engage in activities to the levels of business and mortgage as before the crisis. During the financial crisis, the G20 countries compelled tax havens to sign bilateral treaties providing for exchange of bank information. A positive view asserts that new legislation, exchange of information treaties and transparency initiatives significantly raise the probability of detecting tax evasion (OECD 2011). According to policy makers, “the era of bank secrecy is over” (G20 2009). A negative view, on the contrary, asserts that the initiatives still leave considerable scope for bank secrecy (Shaxson and Christensen 2011). Reuters (2009) reports that the “Swiss bank UBS is threatening to move its headquarters out of Switzerland if the authorities impose too many new regulations in the wake of the global financial crisis”. Further, an increasing number of African countries have established or plan to establish international financial services centres (IFSCs) that offer a combination of low or zero tax rates, limited regulatory standards and anonymity as an incentive for international capital and businesses. Botswana, for instance, established an IFSC already in 2003. Kenya has founded the Nairobi International Finance Services Centre. Plans for a financial services centre in Ghana have been on the policy agenda for several years, though recently put on temporary hold.

Exploiting a unique panel dataset, Johannesen and Zucman (2012) study how the new treaties have affected bank deposits in tax havens. They find that bank clients did not respond to the treaties, but that a minority responded by transferring their deposits to havens not covered by a treaty. Overall, the G20 tax haven crackdown caused a modest relocation of deposits between havens but no significant repatriation of funds. The least compliant tax havens have attracted new clients, while the most compliant have lost some, leaving roughly unchanged the total amount of wealth managed in tax havens. The authors conclude that “the era of bank secrecy is not yet over”.

### 3.3 Customer due diligence and banking in Africa

Banks are expected to have adequate controls and procedures in place so that they know the customers with whom they are dealing. Due diligence are important to establish knowledge of who the true beneficiaries of the funds are and whether the funds are obtained through legal or illegal activities. The due diligence done by banks on their customers is referred to as *Know Your Customer* (KYC). The essential elements of KYC include: (1) customer acceptance policy; (2) customer identification and record-keeping; and (3) on-going monitoring of high-risk accounts. Accordingly, the bank has to check both the identity of the true customer and routinely monitor the accounts (BIS 2001: 5). Adequate due diligence on new and existing customers is a key part of these controls. For anti-money laundering and prevention of terrorist financing strict KYC routines are essential.

The rules and practices for due diligence vary substantially between jurisdictions and between banks, since individual jurisdictions and banks can decide their own due diligence rules. However, the Basel Committee for Banking Supervision has created international recommendations for minimum standards. The purpose of the guidelines is to inform banks and jurisdictions of the importance of due diligence and how due diligence can be implemented, including how to detect and report suspicious transactions. Thus, the guidelines support the *Financial Action Task Force's* (FATF) work on anti-money laundering. The international recommendations can also be used as a benchmark to evaluate at what level jurisdictions and banks are committed to due diligence procedures (UNODC 2007; BIS 2001).

How do the recommended bank regulations fit African realities? According to its own statements, the banking sector is committed to self-regulation and to the adaptation of customer due diligence standards from the Basel Committee on Banking Supervision and the Financial Action Task Force on Money Laundering (BIS 2001). However, the actual compliance to the principles has proved to be weak in many cases. Assessments by the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG) show that although commitment to follow customer due diligence principles are increasing worldwide, many countries are largely non-compliant. There are huge variations between African countries with respect to the level of regulations and their implementation (ESAAMLG 2009a). In Uganda, for instance, banks train their staff in ‘Know your customer’ principles. Yet, in practice the principle is almost impossible to follow since there are no officially recognised identification documents for Ugandan nationals. The lack of acknowledged identification documents opens up for fraud (ESAAMLG 2009b). In South Africa, on the other hand, the system is more developed. In 2007/08 the South African Financial Intelligence Centre received 24,585 suspicious transfer reports (STRs) from banks. What happens after a STR is filed and concern has been raised is, however, another issue. It is questionable whether the South African judicial system has the required capacity to process all the reported cases (FIC South Africa 2007-2008).

Why should banks do due diligence checks of their customers? Banks have incentives to assist wealthy customers with managing their wealth regardless of the origin of the funds, because the nature of the banking business makes large customers attractive (Palmer 2009). Global Witness has documented that high ranking politicians have been helped by banks to transfer large amounts of public funds into secret or hidden private accounts (Global Witness 1999, 2009a, 2009b). However, FATF, the Basel Committee on Banking Supervision and the Offshore Group of Banking Supervisors argue that banks put themselves in a high risk situation if KYC routines are not followed. Serious banks should therefore not engage in business transactions when the legitimate origin of the funds is unclear. Without this due diligence, banks can become subject to reputational, operational, legal and concentration risks, which can result in significant financial costs (BIS 2001).

*Reputational risk* is serious for banks since their business requires that depositors, creditors and the general marketplace trust the bank to be professionally run. As Christian Aid (2008: 8) points out “*It’s a world where reputation is all*”. If there is doubt about the qualifications, integrity and motivations of the bank, there is a risk that clients will leave. The same counts for the *operational risk* if there is doubt that internal processes are practiced efficiently. *Legal risks* open for costly lawsuits and unenforceable contracts that can affect the operations of the bank. If the bank does not do a proper due diligence check the *concentration risk* is unmanaged, and the bank risks to become too dependent of a few clients because the bank management does not have an overview of who and how many independent clients they have (BIS 2001: 3-5).

Although there is considerable risk connected to weak due diligence, several studies and newspaper articles document that banks nevertheless do assist politically exposed persons and powerful, wealthy figures. Global Witness placed the role of banks on the international agenda in 2009 with the report ‘*Undue Diligence. How banks do business with corrupt regimes*’ (Global Witness 2009b). In November 2009, Global Witness published a new study on how banks facilitate illicit flows from developing countries. The report, entitled ‘*The secret life of a shopaholic*’, documents, for instance, how the son of the president of Equatorial Guinea managed to use a network of Western banks to channel large amounts of

public funds out of the country and into private accounts (Global Witness 2009a). The focus of these and similar studies is on Western banks and their lack of compliance to the 'Know Your Customer' principle. The findings are interesting because they show that capital flight and money laundering may be facilitated by Western banks even though these banks often are perceived as more legitimate compared to offshore banks and poorly regulated banks in developing countries.

Banks cannot be separated into 'good' and 'bad' ones (Masciandro 2007). Effective and honest banks may not be aware that funds might be illicit because the money launderer uses skilful methods to avoid scrutiny by bank staff. In honest, but ineffective banks the gaps between good intentions and actual compliance with the regulations can be taken advantage of. There are also dishonest banks that will facilitate illicit activities. Baker (2005:43) explains a method for creating one's own bank to laundering money and taking advantage of innocent depositors. In the volume *'All is clouded by desire'* Block and Weaver (2004) show how the Geneva banker Bruce Rappaport and the Bank of New York worked together with Russian banks to move and launder USD 6 billion for Russian organized criminals and other shady organizations. Thus, the intention behind the bank activity will play a role for policy makers promoting the implementation of stricter KYC regulations. Honest banks, whether efficient or not, will presumably willingly comply while dishonest banks have to be addressed in a different way.

### 3.4 Asset recovery

Major obstacles to the recovery of stolen assets are said to be lack of capacity in developing countries to negotiate the complex legal issues, and the uninterest shown by some developed countries in assisting the repatriation process (Chaikin and Sharman 2009:42). However, banks may also represent a major obstacle. The recovery of illicitly transferred capital requires the collaboration of banks in different countries for information sharing with the authorities, and also for not facilitating the rapid movement of detected funds to new hidden accounts and secret destinations. Repeatedly, investigators experience that banks only provide a minimum of the information required and often stall the process as long as possible, to allow their clients' time to relocate their assets (Basel Institute on Governance 2009; Daniel *et al.* 2008/09; Fofack and Ndikumana 2009; Greenberg *et al.* 2009; Jimu 2009; Pieth 2008).

In *'Recovery of proceeds of crime: observations on practical challenges in sub-Saharan Africa'* Goredema (2009: 34-35) concludes that effective strategies and laws to trace illicit financial flows are still inadequate in the region. Within sub-Saharan Africa there are large regulatory loopholes in many countries, including Angola, the Democratic Republic of Congo, Malawi and Zimbabwe. The countries that have strengthened their legislation to create greater leeway to law enforcement, such as South Africa, Botswana, Swaziland and Tanzania, do not seem to have managed to turn theory into practice and improve significantly. The Abacha-case in Nigeria demonstrates clearly how Western banks give special privileges to powerful customers (PANA 2005; Daniel *et al.* 2008/09).

## 4 Methods applied to channel illicit capital through banks

What methods are used to channel illicit capital out of the country of origin? The literature on money laundering contains detailed descriptions on how financial capital is moved out of countries illicitly with the banks as a tool. The US Permanent Subcommittee on Investigations (2003, 2006, 2008) provides good overviews of methods used by bank to facilitate illicit financial activities. Some of these methods are summarised in Table 1. The information is gathered from criminal investigations on illicit money flows from a wide range of banks and countries, including Nigeria and Gabon.

<b>Table 1: Methods used for illicit transfers of funds</b>	
<b>Methods</b>	<b>How it facilitates or hides illicit activity</b>
<b>Multiple accounts</b> Banker opens multiple accounts in multiple names in multiple jurisdictions for clients	Impedes monitoring and tracing client activity and assets. Allows quick, confidential movement of funds
<b>Offshore accounts</b> "Shell" corporations or trusts formed to hold client assets offshore. Banker opens accounts in the name of offshore entities	Impedes monitoring and tracing client activity and assets
<b>Special name or numbered accounts</b> Banker opens account in code name	Impedes monitoring and tracing client activity and assets. May hide or facilitate illicit activity
<b>Wire transfers</b> Banker facilitates complex wire transfers from multiple accounts to multiple destinations with substantial amounts	Allows quick, complex movement of substantial funds across jurisdictional lines
<b>Concentration accounts</b> Banker conducts client business through one single account that facilitates the processing and settlement of multiple individual customer transactions. The account that co-mingles the funds is used for internal purposes of the bank, but it can also be a method of hiding the origin of funds	Impedes monitoring and tracing of client activity and assets
<b>Offshore recordkeeping</b> Bank maintains client records offshore and minimises or eliminates information in the country of residence	Impedes bank, regulatory and law enforcement oversight
<b>Secrecy jurisdictions</b> Bank conducts business in a jurisdiction which criminalises disclosure of bank information and bars bank regulators from some other countries	Impedes bank, regulatory and law enforcement oversight

Source: US Permanent Subcommittee on Investigations (1999: 45).

Investigations of money laundering and of political and economic elites (PEPs) stealing public funds provide insights into methods used to hide the true origin of the funds and the rightful owners. Banks are often involved in only parts of the money laundering chain and the placement of illicitly gained cash. Thus, improved regulation of the banking sector will only

contribute to solve part of the problem (Block and Weaver 2004; Global Witness *et al.* 2009; Mikuriya 2009).

A more recent banking feature, mobile banking, should be added to the list above. The use of cell phones has opened new possibilities for millions of Africans who were previously without access to banking facilities. South Africa, Cote d’Ivoire, Zambia, Zimbabwe and the Democratic Republic of Congo (DRC) are some of the countries where the service is operating. The cell phone banking facility does not require a pre-existing bank account, and the customer is allowed to open an account without a permanent address. According to Nefdt (2008), the mobile phone service is advantageous to users, but it also opens avenues of exploitation by criminals wishing to launder money without the scrutiny of a bank with regular Know Your Customer routines.

The features listed above are commonly used by both legitimate customers and by those channelling illicit flows out of a country. Thus, the use of the service in itself is not necessarily a warning sign. The Financial Action Task Force (FATF) and the Bank of International Settlements (BIS) have both released lists of what should be regarded to be suspicious activity.

<b>Table 2: Suspicious customer activity in banks</b>	
<b>Financial Action Task Force (FATF)</b>	<b>Bank of International Settlements (BIS)</b>
<ul style="list-style-type: none"> <li>• Unusual business activity</li> <li>• Unable to ascertain source of funds</li> <li>• Large cash deposits</li> <li>• Multiple deposits at different branches</li> <li>• Third party deposits in US dollar cash</li> <li>• Wire transfers following cash deposits</li> <li>• Wire transfers to specific accounts on a regular basis</li> </ul>	<ul style="list-style-type: none"> <li>• Missing documents for identification of customer</li> <li>• Transactions with no obvious economic or commercial sense</li> <li>• Large cash deposits not consistent with normal and expected behaviour</li> <li>• Very high account turnover that is inconsistent with the size of the balance</li> <li>• Transactions through a customer account that is unusual</li> </ul>
<i>Source: FATF (2008: 31)</i>	<i>Source: BIS (2001: 13)</i>

Table 2 lists suspicious customer activities in banks typically used when channelling illicit funds through the formal banking system. Typically banks in secrecy jurisdictions are used. The level of sophistication varies, and the most complex schemes include multiple jurisdictions and a large number of bank accounts in an array of banks. In many cases the money is moved through a maze of shell companies and respectable nominees. Collusion with bank employees at all levels is often found (UNODC 1998:71-73).

Establishment of trusts is another common method used by banks, which makes the identification of the true beneficiary of the funds difficult. The trust service in itself is not necessarily hiding criminal activity. For example, a trust can be established to provide for people who are not yet born. Still, the trust structure allows transfers of funds that cannot be checked for due diligence and know-your-customer requirements (NOU 2009).

In a study of capital flight from sub-Saharan Africa Ajayi and Khan (2000: 227-229) describe common methods facilitating illicit financial flows from Nigeria:

- Carry cash out of the country and change the money into other currencies abroad.
- Smuggling of values across borders in the form of easily transportable valuables such as precious metals and collectibles, for example gold, silver, art and jewellery. Since this method involves smuggling, no banks in the home country need to be involved.
- Systematic overpricing and underinvoicing in trade transactions by both multinational and domestic companies (transfer mispricing). The foreign buyer places the difference in the price and payment into a foreign bank account in the exporter's name.
- Underground banking where movement of capital is done in a system independent of the official banking system in the country.
- Transferring money overseas through commissions and agent fees paid by foreign contractors into foreign bank accounts of residents
- Bank transfers from a local affiliate of a foreign institution to a designated recipient abroad

The methods listed above provide important insights into the role of banks in facilitating illicit financial flows, though several of the methods may not involve banks directly. Although the mechanisms and systems are relatively well known in literature (McCusker 2005; Passas 2003, 2006) the interaction between formal banks and underground banks requires further exploration. One important question for research is whether the activity of underground banks increases when stronger regulations are imposed on the formal banking sector.

Digital payment service has become a new arena for money laundering. Commonly, users have to provide a name, address and date of birth, but the firms may not verify this information. The service provider charge a percentage fee per transfer (e.g. 1%), plus a 'privacy fee' to ensure untraceability. To dodge regulations and avoid creating a paper trail, some payment service providers make users deposit and withdraw funds through third-party 'exchangers'. In May 2013 the US Department of Justice shut down the digital payment service *Liberty Reserve*. Its principal founder and four others were arrested and charged with money laundering. According to *The Economist* (2013), "the defendants are charged with running a money-laundering operation that allegedly acted as 'a financial hub of the cybercrime world', serving credit-card fraudsters, identity thieves, hackers and drug traffickers". The US authorities estimate that *Liberty Reserve* processed 55 million transactions and laundered US\$ 6 billion between 2006 and May 2013. This makes it the largest case in the history of cross-border money laundering.

## 5 Policy considerations

The specific country context is important to take into consideration when addressing capital flight challenges. Further, as argued by Goredema and Madzima (2009), the high levels of corruption that often is linked to capital flight from Africa are likely to put severe constraints on the implementation of reforms. It is also debatable whether recent international initiatives to crack down on bank secrecy and tax havens, initiated by the G8, G20 and OECD countries, effectively can be implemented by poorer countries. This also applies for the new U.S. legislation Foreign Account Tax Compliance Act (FATCA); see Annex 1.

Policy advice can in general be categorised into recommendations for (i) commercial banks, (ii) national governments, and (iii) development agencies and international organisations. As

reflected in the following paragraphs, a weakness with the proposed prescriptions is that they commonly address what *should* be done, instead of what *can* be done in the short and medium run, given the political, economic, financial and institutional constraints facing the implementation of such measures in developing countries.

## Recommendations for banking institutions

- Banks should regularly publish information about their shareholding structures, including details about who owns direct and indirect stakes, i.e. the beneficial ownership of companies, trusts, and other legal entities.
- Clear control mechanisms, policies and procedures should be established to manage risk of money laundering may help bank staff and management to address and mitigate risk.
- Establishment of comprehensive KYC routines to help detecting suspicious transaction and to give guidance on how to act when discovered.
- Better reporting routines to relevant authorities such as the Central Bank or the Financial Intelligence Unit should be established to make the process more streamlined for the bank personnel.
- Compliance officers at the management level should be given the responsibility to ensure that the regulatory framework is used in practice to signal that the area is a priority in the institution.
- Regular training of staff in due diligence and ‘know your customer’ (KYC) principles will give bank officers better knowledge on how to meet the official requirements in practice.

## Recommendations for governments

- Stricter regulations for banks on ownership disclosure, auditing and risk management, responding to international calls for increased transparency and supervision.
- African countries should support calls for G20 member states and other developed countries to create public registries of the true beneficial owners and controllers of corporations, limited-liability companies, and other legal entities.
- Know-your-customer provisions in the laws governing financial institutions should be strengthened to make it illegal for banks and other financial institutions to open new accounts without knowledge of the natural person(s) owning the account(s).
- Identification of bank customers will be more secure with nationally approved and standardised identification papers.
- FATF recommendations will be easier to follow in practice if governments agree on an effective review mechanism.
- FATF member governments should use their position within FATF to make fighting corruption a priority and to ensure that FATF members comply with the standards.
- Governments should establish legislation that makes aggressive, personal marketing of banking in tax havens within the boundaries of their country more difficult.

## Recommendations for international organisations and development agencies

- Internationally organisations should aim to establish legislation that require financial institutions in secrecy jurisdictions and developed countries to collect information on

the ultimate beneficial ownership of an account before accepting transfers into that account.

- FATF should assess whether their guidelines are sufficiently addressing the particular context of African economies which (a) largely are cash based, and (b) rely heavily on a parallel, informal banking system where informal value transfer methods are the norm.
- Illicit flows out of the developing world are a cross-ministerial issue for governments. Development agencies should therefore approach a wide range of institutions in the country they are working in. Counterparts in the treasury, justice, foreign and trade ministries can potentially all be key to coordinate the design and implementation of policies addressing money laundering, corruption and capital flight.
- Asset recovery cases often require extensive juridical knowledge, capacity and resources. Donor agencies should therefore consider to support African governments in building national capacity to fight money laundering and tax evasion, and provide technical assistance and other resources required to follow up asset recovery cases.
- Capacity building and training of bank personnel in due diligence and KYC principles and the rationale behind why these are important should be supported by donor agencies in collaboration with the banking sector.
- NGOs and the media may play an important role in informing the public of cases of and specific challenges of capital flight for the country.

## 6 Concluding remarks

The paper demonstrates that there is a need for more in-depth and detailed knowledge on how banks are involved in and facilitate capital flight from Africa. The level of development and the structure of the banking sector vary substantially across Africa. Thus, there is a need to move beyond regional generalisations and averages, and to focus more on country specific issues. In particular, studies of the relationships between formal and underground banks in individual countries, and the relationships between these ‘onshore’ banks and financial institutions in secrecy jurisdictions, are likely to generate relevant insights for policy design based on solid understanding of the mechanisms applied by banks. Such studies may shed light on the linkages between financial institutions of various types (e.g. formal and informal banks, exchange bureaus, digital payment services, etc.) and finance institutions at various levels (local, national, regional, international and offshore). Much of the current debate, however, focuses mainly on financial centres in secrecy jurisdictions. It is important to gain better understanding of how banks with branches in African countries operate in different settings, and what regulatory frameworks they apply.



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## Annex 1: The Foreign Account Tax Compliance Act (FATCA)

Following the global financial crisis in 2008, serious international policy discussions to crack down on bank secrecy and tax havens take place now as reflected in recent G8 and G20 meetings. The most wide reaching initiative so far is reflected in new legislation by the USA. The Foreign Account Tax Compliance Act (FATCA) targets non-compliance by U.S. taxpayers using foreign accounts. According to Senator Levin, “USA loses 100 Billion USD annually in taxes from money hidden in offshore accounts”. FATCA aims to improve tax compliance involving foreign financial assets and offshore accounts.

Beginning in January 2014, FATCA will require foreign banks and financial institutions to report directly to the U.S. tax administration (IRS) information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. Banks and financial institutions in countries that sign up with FATCA, commit to automatically exchange information on accounts to tax authorities in all countries that have signed FATCA. According to the U.S. Department of Treasury, it is engaged with more than 50 countries and jurisdictions around the world to improve international tax compliance and implement FATCA. The European Union is likely to get an act very similar to FATCA to be effective from 2015.

This U.S. legislation will greatly impact on banks and finance institutions technology systems, operations, and business strategy. Serious doubts have also been raised whether tax administrations have the resources to implement the law. For instance, some members of the U.S. Congress have questioned if the U.S. tax administration (IRS) has the required resources. Tax administrations in Africa are likely to face much more severe constraints to comply with the law.

Links for further reading on FATCA:

<http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx>

[http://www.irs.gov/Businesses/Corporations/Foreign-Account-Tax-Compliance-Act-\(FATCA\)](http://www.irs.gov/Businesses/Corporations/Foreign-Account-Tax-Compliance-Act-(FATCA))

<http://www.pwc.com/us/en/financial-services/publications/fatca-publications/intergovernmental-agreements-monitor.jhtml>

<http://fatca.thomsonreuters.com/about-fatca/>