Study reveals issues with Palau's AML/CFT ratings

Findings in a leading peer-reviewed journal call into question the latest evaluation of Palau's anti-money laundering regime.

APG, an Asia-Pacific anti-money laundering agency, gave Palau lowly 'moderate' ratings on 7 of 11 areas assessed for 'effectiveness' and the lowest possible scores for another three. Assessors accepted that Palau's exposure to terrorist financing is "very limited" and its risk low. With relatively little profit driven crime, they added that the Republic "does not have significant money laundering risks" compared with other countries. Assessors nonetheless gave Palau low ratings, on par with Kyrgyzstan, Nicaragua, Hungary and Costa Rica, and issued a list of "priority actions" to improve its ratings.

The Republic's international reputation and access to financial markets will be affected by these ratings for years, but independent research finds that the assessment criteria doesn't properly evaluate the effectiveness of anti-money laundering regimes.

New criteria seek to assess effectiveness
The Paris-based Financial Action Task Force introduced a new 'effectiveness' methodology in 2013 because compliance with its "40 recommendations" (previously the sole focus of evaluations since 1990) gave no assurance that money laundering regulations were effective.

An extensive process demanding significant resources and preparation by authorities, evaluations now assess anti-money laundering regimes based on two sets of rules: 'technical compliance' with FATF's 40 recommendations, and 'effectiveness' based on 11 'outcome' measures. But the new study reveals major flaws with the effectiveness criteria.

Measuring effort, not outcomes
According to the study's author, Dr Ron Pol from international consultancy AMLassurance.com, "misapplication of outcome labels for what are, in truth, simplistic output and activity measures miss an opportunity to evaluate the real impact of anti-money laundering rules."

He says that FATF's new methodology doesn't evaluate outcomes in the sense generally understood as the *effect* or *impact* of rules. "More meaningful outcome measures, for example, might include the extent to which the system better allows authorities to reduce and prevent crime, and cut the social and economic harms caused by serious crime like drugs-trafficking, corruption, fraud and tax evasion."

"Some of those measures are difficult to evaluate" says Pol, "but assessing anti-money laundering regimes by superficial 'easy-to-measure' metrics" suggests that the intensive rating exercise conveys value more as a rhetorical device than any real measure of effectiveness."

"That's because the current measures largely reflect the efforts of regulatory and enforcement authorities, not whether those efforts have any meaningful impact on serious crime."

'Tick-box' compliance extended
"Moreover", adds Pol, "assessors often use the same evidence to assess both the old and new criteria. But, compressing FATF's 40 recommendations into an abbreviated yet broadly equivalent list of so-called 'outcomes' adds little new evaluative capability beyond 11 more boxes to tick."

"The nature of any 'tick-box' system means that it's possible for jurisdictions to get high ratings without much impact on crime, and vice versa" says Pol. "To their credit, authorities often appear to focus more on crime prevention than better ratings, although close examination of more than 50 evaluations to date reveal ways to achieve both. Nonetheless, although the new ratings system arguably lacks much meaning, low scores have a very real impact on any jurisdiction's access to financial markets."

Effectiveness gap evidence mounting
Another academic paper also notes "enormous" frustration that, despite nearly 30 years of money laundering obligations (now imposed on millions of firms in nearly 200 countries) the "huge and growing cost of compliance has been accompanied by little observable effect". Professors Levi, Reuter and Halliday say that the modern anti-money laundering system is "highly cost-inefficient" and has failed "to produce credible evidence of [its] effectiveness."

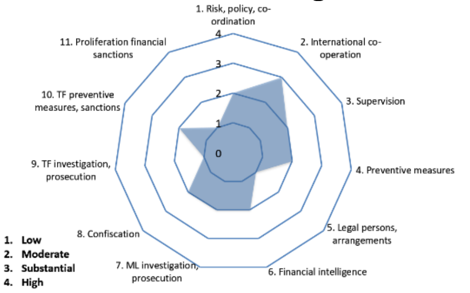
The new study's detailed analysis makes similar findings. It concludes that FATF's new methodology offers few reliable indicators about the effectiveness of money laundering controls.

Positive signs
But the new study ends optimistically. "FATF's frank acknowledgement that evaluating for effectiveness was missing, and important, is a positive step", says Pol. "Likewise, that outcomes matter. FATF also frequently adjusts its standards and guidance as circumstances change. If it accepts that some principles and practices underpinning its effectiveness framework might be improved, that tradition might reasonably be expected to continue."

In the meantime, however, Palau is stuck with poor ratings that offer little meaningful indication about the effectiveness of authorities' efforts to combat the harms from serious profit-motivated crime such as drugs- and human trafficking, sexual exploitation and corruption.

Additional notes

FATF effectiveness ratings: Palau



For the chart at left (& others): Country ratings, Country rankings, Ratings table & 'Immediate Outcome' rankings.

Data source: Mutual Evaluation Report: Palau (September 2018), p12.

About the Financial Action Task Force

- About FATF: here & APG here
- About mutual evaluations: here
- About FATF 'effectiveness': here
- About FATF's 'effectiveness' methodology: here ('immediate outcomes' on p16 & ratings on p21)

Supplementary material: Palau

The new study used 'immediate outcome 7' (money laundering investigations and prosecutions) to illustrate differences between *outputs* and *outcomes*, and why it matters.

Assessors noted Palau's "very low crime rate" and few proceeds-generating crimes resulting in relatively few money laundering investigations. Authorities also "prefer" prosecuting predicate crimes, which they are "well versed in." Although only five money laundering investigations led to prosecutions since 2008, assessors considered it a "reasonable number of money laundering investigations" given the relatively low risk.

However, assessors expressed concern that, except for a "commensurate" focus on drugs-trafficking, most money laundering investigations involved crimes considered lower risk for laundering (tax evasion, theft and misconduct in public office/corruption). There was only one money laundering investigation involving human-trafficking, the second-highest ranked predicate crime risk, despite six human-trafficking prosecutions, and none for other 'high-risk' areas such as the misuse of shell companies and lawyers. Palau therefore got a lowly 'moderate' rating on this measure. Clearly, if authorities conduct a few more money laundering investigations, particularly in areas that match its assessment of high risk, it would likely increase the country's scores.

"But," says Pol, "more money laundering prosecutions (an *activity* or *output* measure) might, or might not, help achieve the (crime prevention) *outcomes* that authorities seek." He often gives a hypothetical example where enforcement agencies detect and prosecute twice as much serious crime but, with prosecutors overwhelmed, no money laundering charges are laid. Authorities might promote this improvement as influencing ratings, but with fewer money laundering cases, the country's 'effectiveness' rating might stay low, or even fall.

"Bizarrely", says Pol "the prospect of lower 'effectiveness' ratings if authorities successfully disrupt significantly *more* serious crime is an unintended consequence of focusing on simple output measures rather than crime prevention outcomes. Ironically, in Palau's case, assessors recorded the doubling of investigations, from 1,240 in 2016 to 2,211 in 2017, yet it's not clear that authorities were given much credit for a measure that might say more about effectiveness than aligning the proportion of money laundering cases with an assumed risk-rating. Just because it can be measured doesn't make it a good measure."

1. **The full study**: Pol, R, F., *Anti-money laundering effectiveness: Assessing outcomes or ticking boxes?* Journal of Money Laundering Control (2018), Vol 21 No 2: http://dx.doi.org/10.1108/JMLC-07-2017-0029. About *Journal of Money Laundering Control*: here. **Companion study**: Pol, R. F., *Uncomfortable truths? ML=BS and AML=BS²*, Journal of Financial Crime (2018), Vol 25 No 2: http://doi.org/10.1108/JFC-08-2017-0071. About *the Journal of Financial Crime* here. **Acknowledgements**. An earlier version of the analysis which formed these articles (in the author's PhD thesis) was reviewed by supervising Professors Jason Sharman (now at Cambridge) and AJ Brown and Duncan McDonnell (Griffith), and examined by Professors Michael Levi (Cardiff) and Louis de Koker (La Trobe), before the journal peer-review process. The author is grateful for their assistance and any errors are his alone.

2. **Other study referenced**. Levi, M., Reuter, P., Halliday, T., *Can the AML system be evaluated without better data?* Crime, Law and Social Change (2017), available here

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The study's author is a political scientist linking public policy with effectiveness. This involves examining not only whether rules exist, or meet recognised standards, or countries adopt them, or even if firms comply with them, but whether they work. Do they produce intended outcomes? Also: 1-page outcome effectiveness & AML/CFT effectiveness profiles.	Tel: +64 (4) 566 5144 Mobile: +64 (27) 241 1163 Email: Ronald.Pol@TeamFactors.com, or Ronald.Pol@AMLassurance.com