

Financial sector reform

A guide to best practice in transparency, accountability
and civic engagement across the public sector

The Transparency and Accountability Initiative is a donor collaborative that includes the Ford Foundation, Hivos, the International Budget Partnership, the Omidyar Network, the Open Society Foundations, the Revenue Watch Institute, the United Kingdom Department for International Development (DFID) and the William and Flora Hewlett Foundation.

The collaborative aims to expand the impact, scale and coordination of funding and activity in the transparency and accountability field, as well as explore applications of this work in new areas.

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The nexus of corruption, economic development and money laundering is embedded in the global financial system. The currently opaque nature of the system attracts the proceeds of corruption and the laundering of those proceeds, thereby stripping critically needed resources out of developing countries. Moreover, the same financial system fosters the trafficking of drugs, arms and people

by creating opportunities to launder revenue from these criminal activities. In addition, tax evasion, in rich and poor countries alike, is facilitated by the ability to hide money in offshore accounts. Without a more transparent financial system, the full potential of work to curtail corruption, limit money laundering and boost economic development and alleviate poverty will not be realised.

Initial steps

Goal

Governments require their banks and other financial institutions to include domestic as well as foreign politically exposed persons (PEPs) as part of their risk-based due diligence when a request to open an account is made. This is in line with Article 52 of the UN Convention Against Corruption and the recommendations of a recent World Bank report.

Justification

The term 'politically exposed person' refers to elected or appointed government officials who are entrusted with a prominent position and persons related to such an individual. Particular attention must be paid to PEPs when they attempt to open accounts with financial institutions because of the higher possibility that they may be in possession of funds that come from corrupt activities. Depletion of capital undermines the ability of poor countries to build their economies and become productive and vibrant participants in the world economy. Further, while a public official will sometimes divert funds for his or her own benefit, he/she may often use accounts and corporate vehicles in the name of family members or associates in order to disguise the origin of the funds.

Porous anti-money laundering regimes in countries where illicit funds are most likely laundered contribute to illicit flows. Indeed, according to a 2009 World Bank Report, there is 'an overall failure of effective implementation of international PEP standards' and '... surprisingly low compliance with Financial Action Task Force requirements on PEPs'.¹

Domestic PEPs must be identified and included in a financial institution's due diligence efforts in order to eliminate opportunities for laundering money, and (as logic would dictate) because a domestic PEP in one country is a foreign

PEP in the eyes of all other nations. By requiring financial institutions to identify all of their customers who are PEPs, whether they are domestic or foreign, and then conduct enhanced due diligence on those deemed to be higher-risk, those institutions will play a far more effective role in curtailing corruption and money laundering.

Recommendations

1. Financial institutions should be required to carry out at least annual reviews of their PEP customers through a senior-level audit committee. This is the best way to ensure that domestic PEPs are included in banks' due diligence procedures. Such a committee would be able to take a bigger picture approach and avoid focusing on individual transactions as opposed to aggregates or trends.
2. If the financial institution is multinational, this committee should examine PEP customers across the group.
3. A customer's risk profile may vary over time and financial institutions must ensure that they are able to monitor the fluctuating risk posed by PEP customers. As part of this process, the financial institution would have to be vigilant in its efforts to keep its PEP lists up to date.

Country examples

Governments with regulations or guidance calling for foreign and domestic PEPs to be included in bank due diligence include Antigua and Barbuda, Argentina, the Bahamas, the British Virgin Islands, Brazil, Bulgaria, Cape Verde, the Cayman Islands, Dominica, the Gambia, Grenada, Haiti, Indonesia, Malawi, Mauritius, Mexico, Montenegro, Pakistan, the Philippines, Qatar, Sierra Leone, South Africa, Thailand, United Arab Emirates and the Virgin Islands.

¹ <http://siteresources.worldbank.org/EXTSARI/Resources/5570284-1257172052492/PEPs-ful.pdf?resourceurlname=PEPs-ful.pdf>

More substantial steps

Goal

Require governments to collect data from financial institutions on income, gains and property paid to non-resident individuals, corporations and trusts. Mandate that data collected be automatically provided to the governments where the non-resident individual or entity is located.

Justification

Globalisation and the liberalisation of economic activity have converted the private sector into a world without borders. This creates a major challenge for national tax authorities because similar changes in their enforcement powers have not kept pace with industry. National tax authorities continue to be constrained by national borders and collecting tax revenue has been difficult.

Additionally, bank secrecy and other confidentiality laws in many jurisdictions (such as tax havens and international financial centres) prevent disclosure of relevant information by financial institutions to government authorities. Further, lax response by tax authorities in those jurisdictions to information requests from foreign governments often delays or prevents cases against tax cheats.

Tax, not aid, is the most sustainable source of finance for development, and tax havens undermine developing countries' efforts to pay their way. The United Nations 2002 Monterrey Consensus and the 2005 UN World Summit require developing countries to mobilise domestic resources for development. This means tackling illicit capital flight and tax evasion. Moreover, the Commentary to the OECD Model Income Tax Treaty and the Commentary to the UN Model Income Tax Treaty both refer to automatic exchange of tax information.

Recommendation

1. A process should be developed and implemented whereby interest income and related tax information are automatically exchanged among other states.

Country examples

The European Union Savings Tax Directive (EUSTD)² is an agreement between the EU member states to automatically exchange information with each other about individuals who earn interest in one member state but reside in another (three EU countries – Austria, Belgium and Luxembourg – have chosen to withhold taxes on accounts held by foreign nationals rather than report account information to tax authorities). The Directive was approved in 2003 and came into effect on 1 July 2005. For example, under the EUSTD, if a resident of Germany holds a bank account in Spain, the Spanish bank will provide details of interest payments on that account to the German revenue authority. This is known as 'automatic exchange of information' and enables each tax authority to compare the amount of income declared by that individual on his or her own personal tax return with the information provided under the EUSTD.

² http://ec.europa.eu/taxation_customs/taxation/personal_tax/savings_tax/index_en.htm

Most ambitious steps

Goal 1

Goal

Governments require and enforce that financial institutions identify the ultimate beneficial owners or controllers of any company, trust or foundation seeking to open an account.

Justification

The flow of illicit money including tax evasion, the proceeds of corruption, terrorist financing and a host of other global ills can be traced to the lack of information available about the beneficial owners of corporations, trusts and foundations. Often located in one of some 70 secrecy jurisdictions around the world, these entities can absorb, hide and transfer wealth beyond the reach of any law enforcement agency, and can often be reincorporated in another secrecy jurisdiction at a moment's notice. No country currently has an effective system of collecting and making available beneficial ownership and control information on corporations and trusts established there. Nor is it completely explicit even in the overarching global anti-money laundering standard established by the Financial Action Task Force (FATF) that financial institutions, when opening an account, must identify the real person who benefits from the funds, and that this cannot be a nominee director or shareholder, or an attorney.

As the collapse of Enron showed, multinational corporations can have thousands of subsidiaries hidden around the world. Corporate entities can use these structures to transfer profits abroad in order to reduce tax liability or to circumvent local regulation in developing countries. Multinationals can use abusive transfer pricing (manipulating prices of inter-subsidiary transactions to shift profits) to divert profit to no- or low-tax jurisdictions, and this is very hard to detect.

Convolved structures of this kind are also commonly used as a way of siphoning off and handling illicit funds, including corruptly and criminally acquired assets, as they enable the true ownership of assets to be disguised, particularly when opening bank accounts and transferring money. The impact of corruption on developing countries is devastating, and these structures help to facilitate it.

Financial institutions, including banks, are required to identify their customers as part of their due diligence on opening accounts, but the true customer is often hidden behind layers of companies and trusts. Then, if money needs to be traced by investigators, these structures also make uncovering the true nature of transactions and tracing beneficial ownership and the origin of funds very difficult. The *modi operandi* of illicit financial flows are not aberrations but part of a broad structural problem.

Due diligence is the first line of defence against the laundering of illicitly acquired funds, so strengthening these procedures increases the integrity of the entire system. Financial institutions will be able to fulfil their regulatory requirement to identify their customers and their sources of funds. Beneficial ownership information collected by financial institutions will help investigators to track down the movement of illicit funds more quickly and effectively. This information will also enable national authorities to better estimate tax revenue (and plan for its utilisation) and to identify where tax is being evaded.

Recommendations

1. Jurisdictions should publish and keep beneficial ownership lists up to date. They should ensure that they collect and maintain a current and publicly available list of the beneficial owners and controllers of corporations, limited liability companies, other legal persons and legal structures, such as trusts organised under their laws.
2. Anti-money laundering laws should be made explicit on beneficial ownership identification requirements for financial institutions. Anti-money laundering laws in each jurisdiction should be explicit that financial institutions must identify the beneficial owners who are natural (i.e. real) persons or listed corporations, not nominee corporations or disguised trusts. Jurisdictions must ensure that these laws are properly enforced, and that the FATF requirements for establishing beneficial ownership as part of the customer due diligence process are rigorously implemented globally.

Country examples

Switzerland is known to have thorough due diligence procedures for customers opening a bank account, and photo identification (a passport or national identity card) is required. However, it is unclear if Swiss banks require photo ID from the person opening the account (which could be an attorney or other legal representative) or from the true beneficial owner of the account.

Goal 2

Goal

Provide greater transparency over how state funds are managed and make it harder for corrupt rulers to exercise personal control over government assets.

Justification

Citizens have a right to know how their countries' funds are being managed on their behalf. This is particularly true in a dictatorship where one individual, or a small cabal, exercises almost complete power over the state. In such cases there is a very thin dividing line between state and personal investments. For example, it appears that the Gaddafi family has significant control over the state funds invested in the Libyan Investment Authority. These funds may look like they belong to the state but are actually under the effective personal control of a ruler who has captured the state.

State accounts from countries with high levels of corruption and poor transparency should raise a serious red flag for banks, in the same way that the personal accounts of politicians from these countries would. Banks and investment managers should not be able to hide behind the shield of holding 'central bank accounts' or 'sovereign wealth funds' in order to do business with corrupt authoritarian regimes.

A solution to this problem of personal control by dictators over state funds is greater transparency, over both funds held and loans made. This would make it harder for corrupt regimes to keep their people in the dark over state assets. It would also make banks think twice before agreeing to manage funds for countries with poor records on human rights and corruption.

Recommendations

1. Banks and other investment managers should be required to disclose full details of all state assets that they manage.
2. The Bank for International Settlements (BIS) should be required to fully publish the bank and non-bank deposits that are reported to it by central banks (e.g. publish this deposit information by countries from which the deposits are received). This information is not published at the moment. BIS collects this information from all central banks, aggregates it and gives a report stating how much a country has deposited abroad in total, but with no breakdown as to where it is held. This is commercial bank deposit data and private deposit data, not central bank data.
3. Banks should be required to publish details of loans they make to sovereign governments or state-owned companies, including fees and charges. Proposed loans should be published in a timeline fashion so that the parliament of the recipient country has an opportunity to scrutinise the deal.

Country example

In 2006 a Global Witness report revealed how \$3 billion of Turkmenistan's gas income was held at Deutsche Bank in Frankfurt under the effective personal control of then dictator President Niyazov.³ Deutsche Bank and the German regulator, BaFin, said that concerns about control of the account were unfounded as these were 'state accounts'. However, a former chairman of the Central Bank told Global Witness that Niyazov treated this money as his personal account. The parallels with the Libyan Investment Authority funds, reportedly managed in London by HSBC and under the control of Colonel Gaddafi's son Saif, are clear.

³ http://www.globalwitness.org/sites/default/files/pdfs/its_a_gas_april_2006_lowres.pdf

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