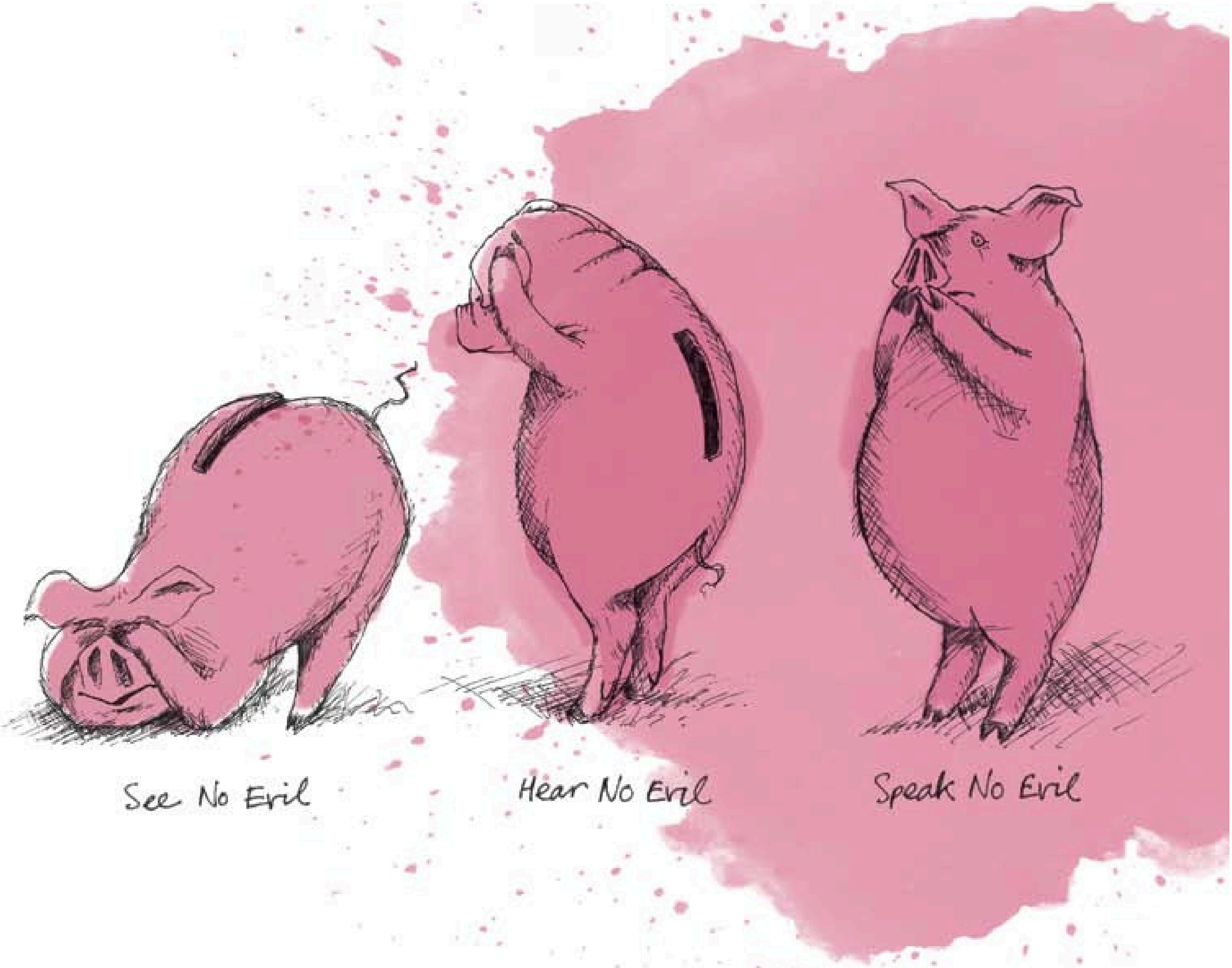


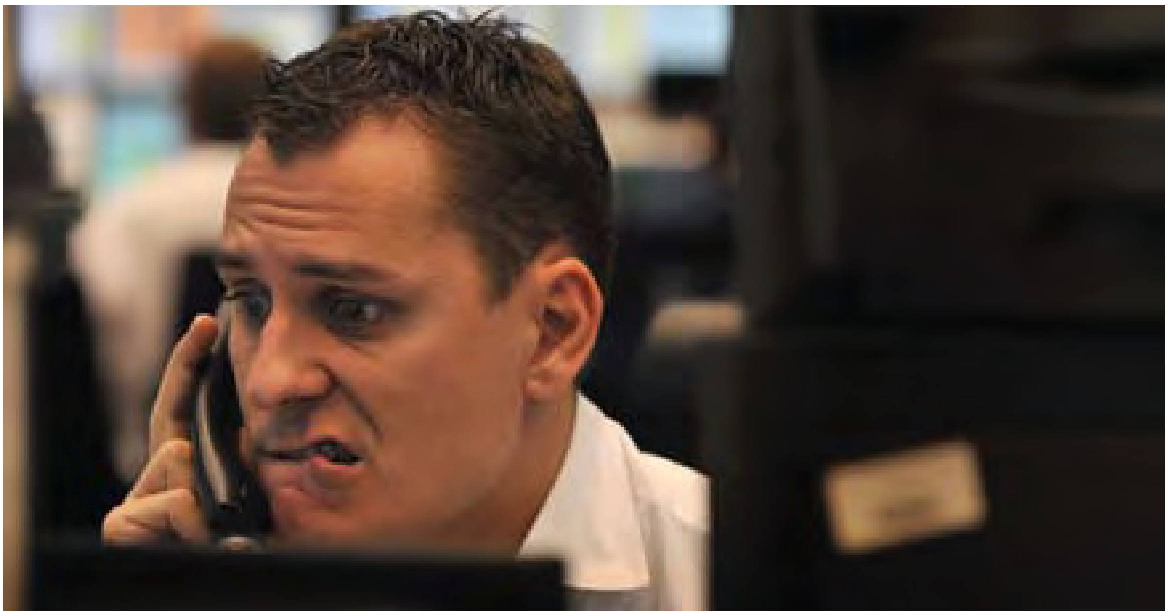
UNDUE DILIGENCE

How banks do business with corrupt regimes

A report by Global Witness, March 2009

global witness

SUMMARY



Economic crisis: banks have damaged the world's richest economies, but by facilitating corruption they help perpetuate poverty in the world's poorest countries.

What is the problem?

The world has learnt during 2008 and 2009 that failures by banks and the governments that regulate them have been responsible for pitching the global economy into its worst crisis in decades. People in the world's richest countries are rightly angry at the increasing job losses and house repossessions.

What is less understood is that for much longer, failures by banks and the governments that regulate them have caused untold damage to the economies of some of the poorest countries in the world.

By doing business with dubious customers in corrupt, natural resource-rich states, banks are facilitating corruption and state looting, which deny these countries the chance to lift themselves out of poverty and leave them dependent on aid.

This is happening despite a raft of anti-money laundering laws that require them to do due diligence to identify their customer and turn down illicitly-acquired funds. But the current laws are ambiguous about how far banks must go to identify the real person behind a series of front companies and trusts. They fail to be explicit about how banks should handle natural resource revenues when they may be fuelling corruption. And if a bank has filed a report on a suspicious customer as required by the law, but then the authorities permit the transaction to go ahead, the bank can legally take dirty money. So it may be possible for a bank to fulfil the letter of its legal obligations, yet still do business with these dubious customers.

By accepting these customers, banks are – directly or indirectly – assisting those who are using the assets of the state to enrich themselves or brutalise their own people. Corruption is not just done by the dictator who has control of natural resource revenues. He needs a bank willing to take the money. It takes two to tango.

This report presents a series of case studies about bank customers in Equatorial Guinea, Republic of Congo, Gabon, Liberia, Angola and Turkmenistan. In these countries, the national resource wealth has or had been captured by an unaccountable few, whether for personal enrichment, to maintain an autocratic personality cult that violated human rights, or to fund devastating wars.

The banks doing business with these customers include Barclays, Citibank, Deutsche Bank, and HSBC. Nearly all of the banks that feature in this report are major international banks and all of them make broad claims about their commitments to social responsibility. Yet there is a grotesque mismatch between rhetoric and reality. Their customers are heads of state or their family members, state-owned companies used as off-budget financing mechanisms by their parent government, central banks in states that have been captured by one individual, and companies trading natural resources out of conflict zones. Banks should have been extremely wary about doing business with any of them.

Why does it matter?

Natural resource revenues offer a potential way out of poverty for many developing countries. But too often, resource revenues that could be spent on development are misappropriated or looted by senior government officials, or are used to prop up regimes that oppress their own people. Banks have a crucial role to play as the first line of defence against corrupt funds, but they are not doing a good job of it.

The key step banks are already required to perform to prevent corrupt funds entering the international system is due diligence, to find out who their customer is and where his or her funds have come from. But the current system is full of loopholes, whether in the anti-money laundering laws themselves, or the way that they are enforced. The result is that the international banking system is complicit in helping to perpetuate poverty, corruption, conflict, human suffering and misery.

This is a serious matter of public interest, both in the countries whose natural resources ought to be paying for development but are

An Angolan mother mourns the death of her child. Angola is Africa's largest oil producer, but has the highest rate of child mortality relative to its national wealth in the world.
Credit: J. B. Russell/ Panos

not, and in the countries whose taxpayers are funding aid to the developing world to fill the gap that is left by corruption and other forms of illicit capital flight. Global Witness is publishing this report in order to provide a tool for productive debate and, hopefully, to contribute to an improvement in banking regulation and enforcement that will have a positive impact on development outcomes for the world's poorest countries. In the current climate of banking meltdown, the report's focus on transparency and the need for assurance that the financial regulatory system is working effectively is of particular public interest.

What can be done?

The changes in financial regulation that are on the way as a result of the global financial crisis also present a chance to tackle the financial industry's ongoing facilitation of corruption.

While the multiple causes of a complex banking crisis are different to the relatively straightforward factors which allow banks to do business with corrupt regimes, there are two identical underlying themes. The first is that when it comes to sticking to the rules, bankers are doing the minimum they can get away with. They aggressively exploit the loopholes and ambiguities in regulations and arbitrage their responsibilities to the lowest level. The second is that regulation by individual national governments is too fragmented to be effective, is hindered by bank secrecy laws, and is not backed by political will.

Global Witness is making the following recommendations, which need to be adopted globally, with effective information sharing across borders. There would be no point in tightening anti-money laundering rules only in Europe and the US if that meant that dirty money then flowed, for example, towards Asia.

1. Banks must change their culture of know-your-customer due diligence, and not treat it solely as a box-ticking exercise of finding the minimum information necessary to comply with the law. Banks should adopt policies so that if they cannot identify the ultimate beneficial owner of the funds, or the settlor and beneficiary if the customer is a trust, and if they cannot identify a natural person (not a legal entity) who does not pose a corruption risk, they must not accept the customer as a client. They should adopt this standard even if they are not legally required by their jurisdiction to do so.

2. Banks must be properly regulated to force them to do their know your customer due diligence properly, so that if they cannot identify the ultimate beneficial owner of the funds, or the settlor and beneficiary if the customer is a trust, and if they cannot identify a natural person (not a legal entity) who does not pose a corruption risk, they must not accept the customer as a client. Anti-money laundering laws must be absolutely explicit, and consistent across different jurisdictions, that banks must identify the natural person behind the funds, investigate the source of funds, and refuse the customer if they present a corruption risk. Regulators are in the front line of ensuring that this is enforced, and should treat the prevention of corrupt money flows as a priority.

This is the scandal at the heart of the system, because customer identification has been the crucial element of money laundering laws since their inception in the 1980s. Yet inconsistencies and a failure by many jurisdictions to be sufficiently explicit about what is required from banks in practice mean that there are still too many loopholes that can be exploited.

While it is important that banks develop their own effective know-your-customer policies, as per the previous recommendation, leaving banks to do it on their own without regulatory oversight will not work, because the avoidance of corrupt funds inevitably involves turning down potential business, and not all banks are willing to do this. The subprime crisis and ensuing credit crunch have shown, among other things, that allowing banks to self-regulate does not work. They consistently claim that they employ the cleverest people in the world and can be allowed to manage their own risk. But if, as they have shown, they cannot safely manage the task that is of greatest importance to them – making a profit – then it seems clear that they cannot be expected to self-regulate when it comes to ethical issues.

3. International cooperation has got to improve. A necessary first step is to overhaul and strengthen the workings of the Financial Action Task Force (FATF), a little known and opaque inter-governmental body that sets the global standard for the anti-money laundering rules that are supposed to prevent flows of corrupt funds. FATF must use its powers to name and shame more effectively, open itself up to external scrutiny, and cooperate with other organisations and government agencies working on corruption.

G20 leaders discuss how to mend the global financial system. November 2008. *Credit: Brooks Kraft/ Corbis*

FATF's members – which include the states that are home to the world's major economies – also need to get their own houses in order before they lecture the small island tax havens who have frequently been FATF's targets. For example, of 24 FATF member states evaluated in the last three years, none were fully compliant with Recommendation 5, which requires countries to have laws in place obliging banks to identify their customer and none had legislation in compliance with FATF's Recommendation 6 which says countries must require their banks to perform enhanced due diligence on politically-exposed persons (PEPS: senior government officials or their relatives and associates, who because of their access to state resources are a heightened money laundering risk). Only four countries were 'largely compliant,' two were 'partially compliant,' eighteen, including the UK, were non-compliant.[1] (See table on page 107)

4. New rules are needed to help banks avoid corrupt funds.

- Each country should publish an online registry of the beneficial ownership of all companies and trusts, and an income and asset declaration database for its government officials.

- National regulators should be required by FATF to assess the effectiveness of the commercial databases of PEPs on which banks rely to carry out their customer due diligence.

- Banks should not be permitted to perform transactions involving natural resource revenues unless they have adequate information to ensure that the funds are not being diverted from government purposes; should be required to publish details of loans they make to sovereign governments or state owned companies, as well as central bank accounts that they hold for other countries; and should develop procedures to recognise and avoid the proceeds of natural resources that are fuelling conflict, regardless of whether official sanctions have yet been applied.

(See page 116 for a full explanation of these and other recommendations.)

The governments of the world's major economies must stand up to make these things happen. If they do not, no other jurisdictions will either. Governments that have bailed out banks and whose taxpayers now own a stake in them have even more incentive to do so. Those governments that have committed themselves to making poverty history, and that claim to be pushing good governance and accountability through their aid interventions, are guilty of hypocrisy if they fail to take responsibility for how their financial institutions and the financial system which they regulate are contributing to corruption and therefore poverty.