Criminals saved our Banks:

The Effect of Money Laundering during the Financial Crisis

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Introduction

In an interview with the Observer (on 13 December 2009) Antonio Maria Costa (head United Nations Office on Drugs and Crime) said that drug money saved our banks during the financial crisis. When banks stopped to lend money to one another this drug money was the only liquid investment capital available. Costa has seen evidence that €238.000.000.000 of drug money were laundered during the financial crisis. In this paper, I will explain how money laundering could have a divergence effect between European countries, especially during the financial crisis.

The paper is structured as follows. After a short overview of the financial crisis, I will explain what money laundering is, how much it happens and why its occurrence during the financial crisis is not surprising. The paper will continue with an overview of the possible effects of money laundering and how money laundering could have a divergence effect between European countries, especially within the European Union. The paper will end with a discussion on the instrument to counter this effect; anti-money laundering policy.

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Financial crisis

What started in 2007 with some sub-prime loans in the US that appeared to be of less value than expected – because US house prices fell and defaults increased – quickly turned into a global financial crisis. While the losses were initially estimated at 50 to 100 billion US dollars by Fed Chairman Bernanke in July 2007, Greenlaw et al. were in February 2008 already forecasting losses of 500 billion US dollars. In October 2008 the IMF (2008) was reasonably sure that losses could be as high as 1400 billion US dollars, which was around 450 billion US dollars more than the figure they had suggested six months earlier. Since the capital reserve assets of the US banking system in 2007 were not much larger than this number, it would have failed if all defaults had been contained within the system. As Honohan (2008) notes, over half of the assets backed by sub-prime loans had been offloaded, mainly on European banks. (Barrel and Davis, 2008) All these losses resulted in liquidity problems for many banks, especially in the US and Europe. These liquidity problems generated distrust between banks, since it became unclear which banks would survive and which bank would become one of the causalities between Northern Rock and two small German Banks in 2007 and Bear Stearns (taken over with government guarantees), IndyMac (failed) and Fanny Mae and Freddy Mac (effectively nationalised) in 2008. (Barrel and Davis, 2008) Costa[2] says that criminals stepped into this liquidity crisis and used it as a chance to launder 352 billion US dollars of drug money. This significant amount of liquid investment capital – about one fourth of the losses estimated by the IMF (2008) – that suddenly became available for banks could have saved them from going bankrupt. This would mean that the criminals of today acted as classical Robin Hoods saving our banks with their own money. To get a full understanding of why this happened, we will have to go into detail of what money laundering is and why it happens.

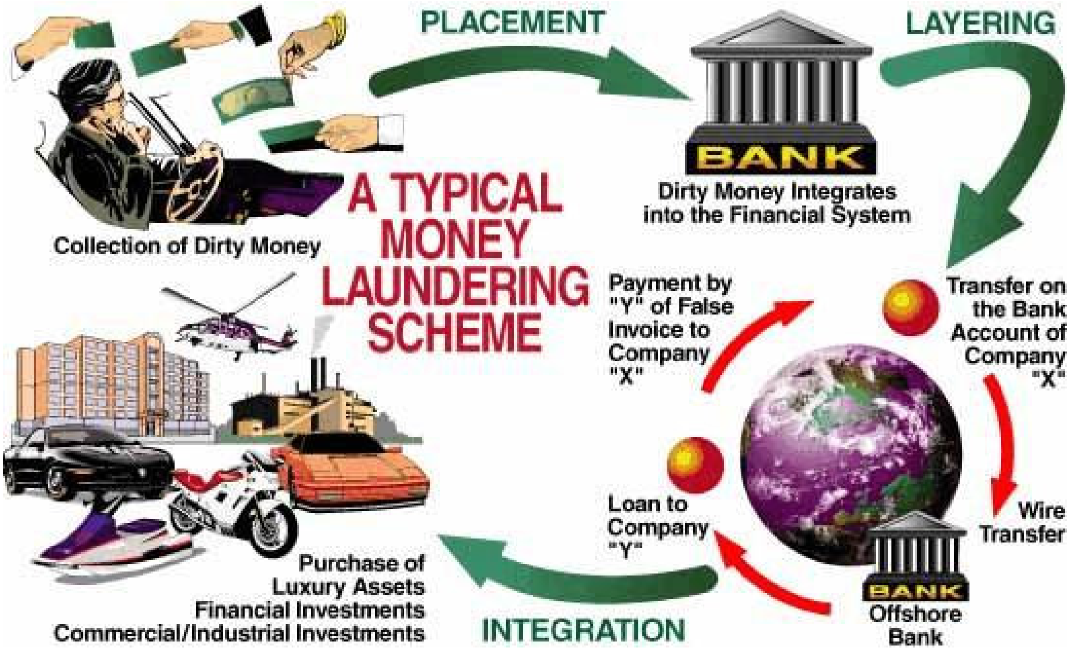
[2] Antonio Maria Costa (head United Nations Office on Drugs and Crime) in an interview with the Observer on 13 December 2009.

Money laundering

"The term 'money laundering' is derived from the habit of the gangster Al Capone funneling his ill-gotten gains through launderettes to construct the pretence of a legitimate income." (van Duyne, 2003, p. 73) With the introduction of the term money laundering, we created two types of money; money that is derived from illegal activities and money that is derived from legal activities. We call the former black money and the latter white money. Although it is impossible to find a difference between the two with a visual inspection, they do have one important difference. The idea is that black money cannot be spend as easily as white money, especially on high value goods that are so attractive for (also) criminals: a big villa in the city centre, a fast (Italian) car, a yacht, jewellery and so forth. Nowadays, one cannot buy such goods with cash money (the seller of the goods is obliged to report it). Moreover, when a criminal is displaying his wealth without an apparent legal source, it might raise the suspicion of, among others, the police. It is therefore needed that criminals set up a money laundering scheme to make their ill-gotten gains appear legally earned. The most important aspect of money laundering is disguising the link between the money and its (illegal) source.

Although there are several money laundering schemes possible, I will explain a typical – and probably still the most-used – money laundering construction.

Figure 1. A typical money laundering scheme



Source: UNODC (http://www.unodc.org/unodc/en/money-laundering/laundrycycle.html)

As shown in figure 1, the money laundering scheme consists of three phases; placement, layering and integration. After the criminal made money with a certain criminal activity (e.g. selling drugs), he tries to get his money into the financial system (put it on a bank account), either by dividing his money into small amounts (so that it will not be detected) or by smuggling it to a country with less strict anti-money laundering regulations. As soon as the money is placed in the financial system, he can start with disguising the origin of the money by sending the money to countries with bank secrecy, transfer it to companies that he controls without stating that on paper, paying false invoices of companies that he (or a friend) controls, and so forth, until it is impossible for investigation agencies to track back the origin of the money. When this layering phase is done, the criminal can finally use the money (integrating it into the legal economy) and spend it on luxury assets to enjoy the life of a successful businessman.

The first step in the money laundering scheme explained above is getting the cash money on a bank account. With the more and more strict anti-money laundering regulations across the world[3], this becomes more and more challenging. Criminals might therefore see their cash proceeds pile up, without the ability to spend their money on the luxurious items they want to have. When you have a pile of cash money at home the liquidity crisis for banks might not really be a problem for you, but actually the chance you have been waiting for. During this liquidity crisis there is a potential win-win situation, with banks that are in desperate need of money and criminals that want to get their ill-gotten gains into the financial system without any questions asked. It is therefore likely that the amount of money laundering peaked during the liquidity crisis, as explained by Antonio Maria Costa (head United Nations Office on Drugs and Crime) in an interview with the Observer (on 13 December 2009), and suggested by the Dutch Financial Expertise Centre[4] and Joras Ferwerda[5] on nu.nl[6] (a Dutch digital newspaper). Although the latter two did not state a figure, Costa said to have seen prove that the amount of money laundering during the financial crisis was 238 billion euro.

One can of course doubt whether the finding of Antonio Maria Costa is a real fact and not an estimation or even been made-up. The general problem with researching money laundering is that it is not easy to observe it directly, because it is hided on purpose by the money launderers. It seems that we just have to deal with that. In this case, the source of the information is trustworthy, from a reliable institution, mentioned explicitly that he has seen evidence, and has no clear-cut reason to lie about it. But can the amount of money laundered during the financial crisis be such a figure? One can never exactly know how much money is laundered (see comment above), but there are some other estimations out there. Once the IMF stated that the annual amount of money laundering world-wide could be between 2-5% of world GDP, which would be around 1000 till 3000 billion euro in 2010. Moreover, John Walker (1999) used an estimation model to estimate the amount of money laundering worldwide at 2850 billion US dollars in 1999.

[3] The blacklist of the FATF, the list of countries with lax anti-money laundering regulations, got empty in October 2006 when Myanmar (Burma), the last country on the blacklist, was removed.

[4] The Dutch Financial Expertise Centre is a multidisciplinary cooperation of seven institutions that have supervision, control, investigation and prosecution tasks in the Dutch financial sector.

[5] Joras Ferwerda is a PhD candidate at the Utrecht University School of Economics in the Netherlands that is specialized in the economics of money laundering and author of this paper.

[6] See http://www.nu.nl/economie/2143523/crisis-wakkert-financiele-fraude.html for the article

Then 238 billion euro is a fairly low figure. Brigitte Unger et al. estimated in 2006 with an adjusted version of the Walker model that the annual amount of money laundering in the Netherlands is about 19 billion euro. Considering the size of the Netherlands, 238 billion euro seems to be not such a strange number.

The question is to what extent it matters that these amounts of money are transferred around the globe? At least they prevent our banks from going bankrupt, to some extent. Unger (2007) presents a list of 25 effects of money laundering on society, which are both positive and negative and have an effect in both the short and long term. This list includes effects on crime rates, economic growth, imports, exports, statistics, terrorism, the solvability and liquidity of the financial sector, etc. (Ferwerda and Bosma, 2007). Since "most literature on money laundering effects is pure speculation" (Unger et al (2006)) we will focus here on the most basic effect of money laundering, being the transfer of capital. This cross-border transfer of capital leads to a extraction of capital in the country where the crime is committed and leads to an inflow of capital in the country where the money laundering (including the integration phase) takes place.[7]

[7] One should notice that the capital flow to the western world that is mentioned is not as big as the estimation of money laundering during the financial crisis. A proportion of these 238 billion euro never crossed borders, because it was already earned in the western world. Moreover, the banks that receive this money can invest it back into the Third World, canceling out part of the effect.

Divergence effect

Walker (1999, p.25) estimated that money laundering worldwide is "heavily concentrated in Europe and North America". The reason behind this geographical concentration is probably the big and advanced financial system in the western world and the fact that it is a good place to enjoy your criminal proceeds and live the luxury life that is adored by these criminals. (Baker, 2005) All over the world, criminals make money with their illegal activities, and when a large proportion of this money finds its way to the western world, it means that it subtracts money from the rest of the world. Baker (2005, 2007) estimates that about 500 – 800 billion US dollars come out of the developing and transitional economies and flow into the financial system in the western world. This means that the need to launder money leads to a subtraction of a significant amount of capital (and therefore potential development[8]) from the developing countries. Baker (2005) concludes that the rich are getting richer and the poor are getting poorer – because the average world income is increasing while also the amount of people living under the poverty level is increasing – and suggests that this movement of capital might be one of the important reasons behind it. It is estimated by Baker (2005, 2007) that:

> *For every dollar of foreign aid sent from the western world to the poor countries, ten dollar flows back under the table because of global illicit financial flows.*

One can imagine that it is hard to develop as a country with these amounts of money flowing out of the country. (Ferwerda, 2010)

Although Baker (2005, 2007) is talking about the world-wide movement of capital, one can imagine that this effect is even bigger within the European Union, because of the abolishment of borders and the free movement of goods, services, capital and persons.

[8] As an economist, I would say that "money is money" and that this money, whether it is black or white, can stimulate the economy.

Anti-money laundering policy

To stop all the effects of money laundering – and especially to stop criminals enjoying their ill-gotten gains – the Financial Action Task Force of the IMF initiated anti-money laundering policies in all the countries in the World, back in 1990, with the introduction of 'the forty recommendations'. The idea was that all countries worldwide had to implement these forty recommendations to ensure them to have effective anti-money laundering policies. All countries that were not compliant with these recommendations were put on a blacklist and were therefore named and shamed worldwide.[9] Since these forty recommendations are essentially soft law, the European Union took this initiative one step further by introducing hard law, most recently with the Third anti-money laundering Directive[10] and Implementing Directive[11]. At the moment, a research team from Utrecht University (the Netherlands) is assessing, in a project funded by the European Commission[12], to what extent the EU Member States have effective anti-money laundering policies and whether they are able to reduce the amount of money laundering. Although we might not be able to stop money laundering completely, research (Ferwerda, 2009) suggests that anti-money laundering policy cannot only stop the direct effect of the movement of capital but could also reduce the amount of crime. [13]

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[9] For more information about the use of blacklists by the FATF and IMF, see Unger and Ferwerda (2008 or 2009).

[10] Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, OJ L 309, 25 November 2005, p. 15 (Third Directive).

[11] Commission Directive 2006/70/EC of 1 August 2006, laying down implementing measures for Directive 2005/60/EC of the European Parliament and of the Council as regards the definition of 'politically exposed person' and the technical criteria for simplified customer due diligence procedures and for exemption on grounds of a financial activity conducted on an occasional or very limited basis, OJ L 214, 4 August 2006, p. 29 (Implementing Directive).

[12] Project 'ECOLEF': The Economic and Legal Effectiveness of Anti-Money Laundering and Combating Terrorist Financing Policy, Project funded by the European Commission, DG Justice, Freedom and Security 2010 - 2012 JLS/2009/ISEC/AG/087

[13] In his research, Ferwerda (2009) found that stricter anti-money laundering policies, especially international cooperation, are associated with lower crime rates in 17 Western countries.

Conclusion

The financial crisis started with sub-prime loans in the US that lost some of their value and lead to big losses for the financial sector worldwide. When banks were in need of liquidity to cover these losses, criminals offered them their ill-gotten gains, thereby saving the banks. The criminals did not do this with the intention to become the modern Robin Hoods and to save the banks, but to launder their criminal proceeds. In an interview with the Observer (on 13 December 2009) Antonio Maria Costa (head UN Office on Drugs and Crime) said that he has seen evidence that 238 billion euro of drug money were laundered during the financial crisis. Criminals derive money from their illegal activities, but are unable to spend them directly on the luxury goods (villas, cars, boats) they want. Before they can purchase these luxurious goods, they have to make their criminal proceeds appear legal, which is called money laundering. Traditionally the majority of money laundering through the financial system takes place in the big financial centers around the world. In fact, the need to launder ill-gotten gains leads to capital flows from all over the world towards Western Europe and the US. This inflow of capital can foster the economic growth in the West, while the crime hampers the growth in the rest of the world. This shift could be especially apparent within the EU, because the abolishment of borders made cross-border transports of goods, services, capital and persons a lot easier. To counter this divergence effect we are in need of effective anti-money laundering policies within the EU. The European Commission initiated this with the introduction of the Third Anti-Money Laundering Directive and Implementing Directive. At the moment, a research team from Utrecht University, the Netherlands is assessing, in a project funded by the European Commission, to what extent the EU Member States have effective anti-money laundering policies and are able to reduce the amount of money laundering.

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