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Concept Note - Identifying activities/sectors vulnerable to generating IFF

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CONCEPT NOTE

Identifying activities/sectors vulnerable to generating IFF

SUMMARY: Possibilities to generating illicit financial flows (IFF) are manifold, ranging from economic and financial crimes to activities on the edge of legality. Given the complexity of economic and financial crimes and the limited resources in developing countries, it is important that they are able to identify, and respond to, their priority vulnerabilities.

This concept note proposes to develop a tool to help developing countries to identify which distinct issues pose the largest threat to a country in the area of IFF. The tool should also weigh the amount of costs/inputs necessary in order to have an effect on making a sector more resilient. It will be available to partner countries’ stakeholders to help them better determine risks, prioritise and design appropriate responses and to promote a whole of government approach to combating sources for IFF.

I. Background

For the purpose of this concept note, economic and financial crimes are defined as: crimes carried out with the primary objective of economic and financial gains. Definitions differ¹; countries as well as international organisations utilize varying legal definitions (Bussmann and Werle, 2006; UNODC, 2005).

Usually, economic and financial crimes comprise a number of criminal practices, ranging from high level corruption and theft of state funds to small scale commercial fraud. Other types of activities cannot be explicitly labelled illegal or criminal but also result in a loss of state resources (for example, small and irregular scale mining may result in unpaid royalties but the individual diggers involved are likely to be engaged in this as a livelihood and are not criminals – therefore the activity requires a different set of responses beyond criminalisation). What they all have in common is that they incur a loss of resources for victims, be they individuals, firms or state institutions. The very recent/current issue of illicit financial flows essentially refers to the revenues generated by a set of such activities or funds transferred using illicit means.

Fighting crimes with extremely limited resources is particularly challenging, and developing countries are increasingly aware of their specific challenges in addressing a vast set of threats with extremely limited resources. In addition, developing countries are often more exposed to socio-economic mechanisms that further exacerbate the situation. Examples are economic stagnation which often incentivises criminal behaviour. In some instances, economic and financial crime allows for the establishment of parallel power systems and economic structures that can rival or threaten the state, thus undermining state authority. Combating all forms of economic and financial crimes is thus a priority for many partner countries. However, fighting these crimes requires expertise and funds. Allocating sufficient resources for economic and financial crime is a problem for all countries (Borgers and Moors, 2007). In addition, developing countries often do not have access to the kind of technical expertise required to investigate and prosecute economic and financial crimes. It is therefore of utmost importance for developing country’s authorities to identify where to deploy their relatively scarce skills and resources by having knowledge about how their illicit losses are comprised.

This requires good analytical and diagnostic tools to properly assess risks – including the likelihood and impact of certain activities and then identify and prioritize appropriate responses given current constraints.

¹ As UNODC (2005) discusses, the difficulties related to defining types of crime covered by the term ‘economic and financial crime’ are plenty, if not only because recent advances in technology have created new forms of economic crime non-existent a few decades ago.
A number of risk assessment tools exist and are being used. Few countries though take a comprehensive and whole of government approach to identifying the source of the illicit funds. Most assessments are being carried out for specific crimes and by specific institutions such as tax authorities, financial intelligence units (FIUs), etc. For example, FATF provides a specific methodology to evaluate the level of technical compliance with anti-money laundering standards and effectiveness of the implementation of such policies (FATF, 2013). In other words, this methodology allows a country to identify whether certain sectors (banking, real estate…) are vulnerable to being used for laundering money. But it does not identify where that money is generated. The OECD developed a Transfer Pricing risk assessment tool (OECD, 2013a).

There is no overarching tool to assess which activity or activities generating illicit financial flows pose the largest threat to a country. Such a tool could prove central in helping countries respond by shaping and directing scarce resources towards those presenting the largest losses, thus achieving the biggest impact. Given the complexity of economic and financial crimes, differentiated responses are needed. A risk assessment that can help in answering the question ‘where are a country’s largest vulnerabilities’ would be a useful tool for the authorities in a developing country. Likewise, such a tool should be able to weigh the amount of costs/inputs required to have an effect in making a sector more resilient.

The challenge of an overarching risk assessment tool is compounded by the silo tendency of institutions, which rarely work together, focusing solely on their area of responsibility. Tax authorities, FIUs, bank supervision authorities, etc. are often unable to share information that would help them uncover and/or take a strategic approach to combat criminal activities. An OECD study on the practices of tax authorities in numerous countries, including a few developing ones, found that successful prosecution of tax crimes is more likely when the different agencies working on financial crimes exchange information (OECD, 2013b). However, the study also revealed that tax authorities are sometimes unable or unwilling to share important tax related information with other institutions for the purposes of combating economic crimes. Tax authorities are one example illustrating a common modus operandi in national authorities: work in silos, falling short of the impact the authorities could have if they worked together.

To mitigate these shortcomings, a more overarching approach is needed: pulling together various institutions to scan the situation in a given country, generating a more integrated and complete picture of the set of activities that may generate illicit financial flows. Conducting such an assessment exercise would look at vulnerabilities of different sector or activities through a collaborative approach involving several authorities.

II. Objectives of this project

This concept note proposes to develop a comprehensive risk assessment tool that responds to the context elaborated above. Once developed and validated, this tool will be available to partner countries’ stakeholders to help them fight economic and financial crimes: better determine risks, prioritise and design appropriate responses and to promote a whole of government approach to combating economic and financial crimes.

This tool would also be useful for providers of development assistance, helping them focus assistance on responses that are priorities of partner countries. Reform priorities are often determined by the supply of

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2 For example the IMF Staffs’ Money Laundering and Terrorist Financing National Risk Assessment Methodology or the World Bank’s Risk Assessment Methodology. The latter one includes in a first step a threat analysis, having a look at prevailing crime types which is the primary concern of this concept note. Similar analysis have been done inter alia by Australia, the Netherlands, New Zealand, the US, while only some took a look at originating sources (activities or sectors).
donor support rather than recipient needs based on actual assessments, priority setting and a serious consideration of alternative options. The illicit flows agenda risks becoming such a trend.

The international element of the illicit financial flows agenda makes it an important topic in policy debates, creating focus on the international element, when in fact some countries may have larger domestic challenges to deal with. For example it would be wrong to focus scarce resources only on transfer pricing practices of multinational enterprises if the country is not hosting a significant number of MNEs. Similarly, it would be inefficient to focus on strengthening banking supervision if the country’s economy operates predominantly in cash. The appropriate areas to focus on can be identified through a careful and thorough risk assessment.

A comprehensive risk assessment, involving all relevant institutions, should generate evidence based priorities which should assist generating political support for action.

III. Proposed plan and methodology

The OECD Development Cooperation Directorate proposes to develop a risk assessment methodology to be applied by developing countries authorities in order to identify sectors most vulnerable to generating illicit financial flows. This risk assessment methodology could include at least an initial estimation of the necessary inputs needed to have an effect on making the identified sector more resilient given the scarce resources and often limited statistical information in developing countries. The process to arrive at such methodology would be rolled out through the following stages:

Stage 1.) Development of risk assessment tool for partner countries:
- Design of a methodological framework, taking into consideration the potentially limited reliable data on economic and financial crimes collected by local authorities.
- Categorisation and definition of activities, crimes and sectors to be analysed by the tool.
- Threats should be assessed on the basis of the likelihood of the crime occurring, and the impact of the specific crime (on society, the economy, etc.)

Stage 2.) Desk-based country studies and field validation of the methodology
- Identify 4 developing countries committed to combating economic and financial crimes.
- Conduct desk-based reviews on the basis of available information provided by the authorities of the four countries.
- Identify data gaps, including where additional information would be sought through expert surveys or other means of data gathering.
- Complement desk study with field visits to conduct additional surveys and data gathering.
- The desk based study could include an initial overview of existing institutional structures responsible for combating economic and financial crimes and their performance.
- In addition, the analysis should offer recommendations for addressing the identified core-challenges in the country.

3 This is not to suggest that bilateral development agencies do not have a contribution to make in promoting change at the international level too.
4 An estimation of the necessary inputs would go beyond an overview of existing structures (human, financial and technical capacities) as in stage 2. Instead it would estimate which amount of inputs is needed and for example also include exogenous factors to the mere crime combating institutions, like political willingness. The scope of this part of the concept note his however debatable.
5 A rather extensive examples of categorisation can be found in the FATF Guidance on National Money Laundering and Terrorist Financing Risk Assessment (2013) or a shorter example in the EUROPOL Serious and Organised Crime Threat Assessment (2013)
Stage 3.) Dissemination and validation of the Risk Assessment Tool

- Capture key lessons and good practices from stage 2, and amend the tool accordingly.
- Conduct in-country workshops to present and validate findings and analysis, including the criteria and weightings for determining risk levels and likely impact of most prevalent crimes

Building on the findings from the national risk assessment, the country should be able to develop an operational plan to combat Economic and Financial Crimes that would set out priority areas, specific actions, available budgetary resources and institutional responsibilities for implementation, reporting and monitoring.

Access to data

A proper risk assessment will need to rely on data to get a sense of the absolute and relative level of a certain crime in a country. However, gathering reliable data and statistics is likely to be challenging. Accessing information on criminal activities, hidden by nature, poses particular difficulties in any context, but especially so in developing countries, where statistics are generally of lower quality. Relying entirely on criminal statistics will give a picture of law enforcement rather than the actual crime picture, and so would need to be complemented by additional survey data. Data sources would be official statistics and administrative data. This would need likely to be complemented by more targeted surveys and/or interviews amongst relevant judicial and law enforcement authorities, but also other knowledgeable and relevant individuals in the banking sector, tax authorities, customs authorities, exporters, importers, etc.

Cross government engagement

The development of the diagnostic tool requires testing and validation through case studies. The process of in-country validation would initiate a broader engagement framework in which several authorities involved in combating financial and economic crimes would come together within the context of this work. Collaboration on data collection, for example, will require a multi-stakeholder engagement process. This engagement is to be led by a relevant high level authority (possibly by the Ministries of Justice or Finance) and should include all relevant institutions, such as tax and customs authorities, magistrates, relevant line ministries, in an effort of collecting data, and defining priorities based on the risk assessment.

Final considerations

As a result of this project, developing countries’ authorities and donors would benefit. Developing countries would have available a tool to be applied by their own institutions and reflecting the reality of availability of data encountered in these countries. It is expected that such initial incentive for collaboration contributes not only to identifying areas of vulnerability but also to overcoming lack of trust and the “silo approach” often encountered. In addition, such an approach fosters political support for any resulting policies and strategies.

Donors operating in these countries would also be able to use the tool to guide their decisions on how to engage with the issue of IFF in the developing countries where they operate. The application of the tool by donors would provide them with more information on which activities present more vulnerabilities and signal areas where efforts could have higher likelihood of positive impact.
References


International Organization of Supreme Audit Institutions (INTOSAI, N.D.), Guidelines for Internal Control Standards for the Public Sector (INTOSAI GOV 9100), Vienna.


