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# Economic Impacts of Money Laundering

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A comparative analysis between Portuguese  
and British realities

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## a) Abstract

Money Laundering is a global phenomenon with social, political and economic consequences which impacts on the capacity of societies and businesses negatively. The existence of illicit flows generates economic distortions such as the erratic use of the resources, disinvestment on licit economy, the weakening of the banking sector, the loss of attractiveness for FDI or the promotion of criminal activities. In the private sphere, there are also several cases of businesses seriously harmed by Money Laundering operations.

In this context, it is important to know the consequences of Money Laundering in both governmental and private fields, as well as understand what can be done to combat this phenomenon. This Dissertation is based on data collected for two different countries, Portugal and UK, where it is possible to observe some differences and, consequently, get some clues about what can really matters to prevent Money Laundering.

As conclusions, this Dissertation desires to demonstrate that countries with efficient legal systems and economically more oriented tend to achieve better results combating Money Laundering, which consequently increases the capacity of these countries to attract FDI, reduce corruption or squeeze the volume of transactions in Shadow Economy.

Not surprisingly, the private concerns are similar. Nowadays, Financial Institutions really care about compliance issues in order to prevent fees and other penalizations, but most important than that, they truly need to prevent reputational crisis. Hence, for the countries where investors are more sensible to these aspects, privates also seem to be more aware addressing compliance norms.

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## c) Table of Contents

		Page
a)	Abstract.....	i
b)	Acknowledgements.....	ii
c)	Table of Contents.....	iii
d)	List of Abbreviations	V
<b>I</b>	<b>Introduction</b>	<b>1</b>
<b>II</b>	<b>Literature Review</b>	<b>3</b>
1	Money Laundering: Conceptual Introduction.....	3
2	Anti-Money Laundering Frameworks.....	4
2.1	An Overview.....	4
2.2	Rule-Based Approach Vs Risk-Based Approach.....	5
2.3	Anti-Money Laundering Criticism.....	7
2.4	The Private Contribution: Compliance and Due Diligence.....	9
3	Countries Comparison.....	10
3.1	Social Comparison.....	10
3.2	Legal Comparison.....	11
4	Economic Impacts of Money Laundering.....	13
4.1	Economic Models.....	13
4.2	Sensible Variables.....	14
<b>III</b>	<b>Methodology and Data Collection</b>	<b>16</b>
1	Conceptual Framework and Research Questions.....	16
2	Methodology.....	17
3	Data Collection.....	18
3.1	Choosing Data: Underlying Reasoning.....	18
3.2	Sources of Information.....	20
3.3	Data Collected.....	20
<b>IV</b>	<b>Data Analysis and Discussion</b>	<b>21</b>
1	First Research Question: <i>Microeconomics: Does Compliance pay off in the long run?</i> .....	21
2	Second Research Question: <i>Macroeconomics: What are the economic impacts of an inefficient AML Framework?</i> .....	25
<b>V</b>	<b>Conclusions</b>	<b>31</b>
<b>VI</b>	<b>Limitations and Future Research</b>	<b>34</b>
1	Limitations.....	34
2	Future Research.....	35
<b>VII</b>	<b>Annexes</b>	<b>36</b>
1	<i>Annex 1: How to launder money: Theoretical Steps.....</i>	<i>36</i>
2	<i>Annex 2: Economic Models.....</i>	<i>38</i>
3	<i>Annex 3: Hofstede Results.....</i>	<i>43</i>
4	<i>Annex 4: Brief Architecture of Portuguese Law Enforcement and Prosecution System.....</i>	<i>44</i>
5	<i>Annex 5: Brief Architecture of British Law Enforcement and Prosecution System.....</i>	<i>46</i>
6	<i>Annex 6: Brief Architecture of Portuguese and British Financial Market Supervision.....</i>	<i>48</i>
7	<i>Annex 7: British private Bodies working on AML Framework.....</i>	<i>51</i>
8	<i>Annex 8: Status of Implementation of FAFT-GAFI Recommendations in Portugal and UK.....</i>	<i>52</i>
9	<i>Annex 9: International Institutions with AML Action.....</i>	<i>55</i>

10	<i>Annex 10: Other sensible variables referred on academic literature.....</i>	59
11	<i>Annex 11: Timeline for Northern Rock bank crisis.....</i>	62
12	<i>Annex 12: Timeline for BCP Leadership Crisis.....</i>	63
<b>VIII</b>	<b>Appendixes</b>	<b>64</b>
<b>IX</b>	<b>Interview Guide</b>	<b>71</b>
<b>X</b>	<b>References</b>	<b>76</b>

## **d) List of Abbreviations**

<b>ABI</b>	Association of British Insurers
<b>ARA</b>	Assets Recovery Agency
<b>BBA</b>	British Bankers Association
<b>BdP</b>	Banco de Portugal
<b>BoE</b>	Bank of England
<b>CMVM</b>	Comissão do Mercado de Valores Mobiliários
<b>COPFS</b>	Scottish Crown Office and Procurator Fiscal Service
<b>CPS</b>	Crown Prosecution Service
<b>DNFBPs</b>	Designated Non-Financial Businesses and Professions
<b>EU</b>	European Union
<b>FATF</b>	The Financial Action Task Force
<b>FDI</b>	Foreign Direct Investment
<b>FIU</b>	Financial Investigation Units
<b>FSA</b>	Financial Service Authority
<b>GPML</b>	Global Programme Against Money Laundering
<b>HMT</b>	Her Majesty's Treasury
<b>IMF</b>	International Monetary Fund
<b>ISP</b>	Instituto Seguros de Portugal
<b>JMLSG</b>	Joint Money Laundering Steering Group
<b>KYC</b>	Know Your Customer
<b>ML</b>	Money Laundering
<b>MLAC</b>	Money Laundering Advisory Committee
<b>PEPs</b>	Political Exposed Persons
<b>PPSNI</b>	The Public Prosecution Service Northern Ireland
<b>SOCA</b>	Serious Organized Crime Agency
<b>UN</b>	United Nations



## I. Introduction

Money Laundering phenomena are vast and complex (Eurostat, 2010). It is a usual crime fully spread over the world and it is commonly related with other crimes, since drug traffic until the more intricate terrorist scheme (The World Bank, 2006). Furthermore, there is a huge lack of knowledge about it. Authorities can calculate quite accurately, for example, the dimension of opium fields through the Google Earth software, however, there is no monitoring system able to predict the dimension and the occurrence of money laundering flows (Walker and Unger, 2009). So, in the last years, different international authorities such as Financial Action Task Force (FAFT) or United Nations (UN), among others, have done pressure to put in place systems against money laundering.

Thus, the focus of this Master Dissertation will be an economic analysis of Anti-Money Laundering (AML) Frameworks (Portugal and UK will be the countries observed) and their consequences. To do it, this Dissertation will start with a conceptual overview, which includes both the national architectures of AML Frameworks in Portugal and UK and international structures, and an economic analysis based on models developed previously.

Then, it will be observed some micro and macroeconomic impacts of money-laundering phenomena and consequently, the impact of AML Frameworks in economies. This analysis will be split up into two different Research Questions. The first one is micro-oriented and it tries to understand if private entities, namely financial institutions, should be proactive regarding their compliance departments, or if on the other hand, compliance is not profitable.

Notice that this issue is very important for two different reasons. First of all because private endeavour put into the AML Frameworks influences its effectiveness (Barth and Wolff, 2009), and secondly as a way to stress that rent-seeking behavior of individuals is always present, so the alignment between individuals interest and social benefit is crucial (Pellegrina and Masciaro, 2008).

The second Research Question attempts to measure or, at least, to give some important insights about the impacts of AML Frameworks on different sensible variables such as Foreign Direct Investment (FDI), corruption or dimension of shadow economy.

Based on these conclusions, it will be possible to better predict macroeconomic deviations caused by an AML policy.

Both Research Questions will be answered through a comparison between Portugal and UK based on Data Collected and supported by a theoretical discussion based on economic models presented in Literature Review.

Lastly, this Dissertation presents a personal interpretation of the study and the opinion of the author about the issues discussed in the next pages.

## II. Literature Review

### 1. Money Laundering: Conceptual Introduction

In order to start drawing some considerations about Anti-Money Laundering (AML) there are some important aspects that has to be defined previously. It is quite obvious that AML activities aimed at preventing the underlying crime: Money Laundering (ML) Thus, the first step of this investigation has to rely on the concepts associated with ML.

ML can be defined as the process by which any types of illegal proceeds are disguised to conceal their illicit origins. In this sense, ML involves the proceeds originated by criminally derived property rather than the property itself (The World Bank, 2006).

ML is a criminal trend recognized since 1988, in United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances. In this convention, ML was identified as “The conversion or transfer of property, knowing that such property is derived from any offense or offenses or from an act of participation in such offense or offenses, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of such an offense or offenses to evade the legal consequences of his actions”. This primary definition stresses the ideas of both disposition/movement of properties and acquisition/possession of any properties derived from illicit acts (Vienna Convention, 1988). However, as Vienna Convention is about drug trafficking offenses and ML offenses are always the application of proceeds that came from underlying criminal activities, different crimes such as fraud, kidnapping and theft did not constitute ML offenses according to Vienna (The World Bank, 2006).

Nowadays, the definition of ML is perceived as being the same process characterized in 1988 but with a larger range of underlying crimes behind it. This is in line with the trend identified by Third Directive of European Parliament (EU, 2005)<sup>1</sup>. The most recent contributions pointed out the idea that ML is the last link of any criminal chain. ML

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<sup>1</sup> See PDF Version of European Directive in: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:309:0015:0036:EN:PDF> [accessed 16 May 2011]

does not value itself, but it is the crime that enables criminal behaviors to be profitable (Ferwerda, 2009). Thus, ML is by-product of other crimes.

A current definition of ML could be “the processes where criminal proceeds are disguised from their illegal origin with the purpose of legitimize the illegal proceeds” (see Annex 1) (FATF, 2011). In 2000, UN had already introduced a new definition through the Palermo Convention where it was required to all signatories to apply “the widest range of predicate offenses” (Palermo Convention, 2000)<sup>2</sup>. By way of summary, FATF wrapped up the definitions of Vienna and Palermo and came out with a public list of offenses that were included as predicate offences for ML (FATF,2003).

From the economic point of view, ML has been seen as the action in which an agent sets up a procedure for transforming a given amount of potential purchasing power into actual purchasing power reducing incrimination costs (Masciandaro, 1998). Following this definition it should be expectable that statistical studies had reached an accurate estimation of the money involved, however, these are calculations that seems almost impossible to assess (Reuter and Truman, 2004). In 1995, the prototype of Walker Model suggested that 2.85 trillion US\$ were laundered globally (Walker and Unger, 2009). Three years after, in 1998, International Monetary Fund (IMF) estimate that “2 to 5 percent of global GDP would probably be a consensus range” to ML. At that time, the value represented 1.5 trillion US\$ (Camdessus, 1998). In 1996, an estimation based on statistics of the year predicted that the total amount of money involved in ML schemes should be between the interval 590 billion US\$ and 1.5 trillion US\$ (Tanzi, 1996).

## **2. Anti-Money Laundering Frameworks**

### **2.1 An Overview**

An AML Frameworks is the essential structure that each country has to combat ML. It is responsible for preventing, detecting and repressing ML events (Rocha, 2011). This conceptual division is also expressed by the two pillars of AML Regime: Prevention and Enforcement. Supervisors are responsible for Preventions while the second pillar is

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<sup>2</sup> See the PDF version of the document in:  
[http://www.uncjin.org/Documents/Conventions/dcatoc/final\\_documents\\_2/convention\\_eng.pdf](http://www.uncjin.org/Documents/Conventions/dcatoc/final_documents_2/convention_eng.pdf)  
[accessed 16 May 2011]

ensured by Law Enforcement bodies. Supervisors play an important role addressing confidence to the market (Warren, 2008) and after the recent crisis, some authors claimed for a more committed supervision (Bradley, 2009).

Indeed, AML interact with the three main areas of deterrence policies against crime: it investigates, increasing the probability of criminal detection; it regulates, clearing concepts and judicial strategies; and considering that reduces the dirty money available, it extracts wealth from criminals (Garoupa, 1997). These functions are very important since they affect the variables which ensure the economic efficiency of crime (see Annex 2). In other words: ensuring that crime does not pay (HM Treasury, 2004).

## **2.2 Rule-Based Approach Vs Risk-Based Approach**

AML frameworks can be designed according to two different approaches. Rule-based approach encompasses government regulations imposing norms and laws for every social actor. On the other side is the Risk-based approach, where law-makers give to agents more freedom regarding their behaviors and obligations. Criteria become vague and financial institutions are responsible to decide whether report or not (Unger and Waarden, 2009).

Rule-based approach seems to be more efficient in theory. According to some authors, it produced insufficient information to fight ML and FT. In countries where risk-based approach is not in place and the system works only based on rules and laws, the outcome of AML is low. As a consequence, ML prosecutions are low too (Reuter and Truman, 2004). Laws are too vague and financial institutions are not able to distinguish ML activities from normal ones. The notion of “suspicious” becomes vague (Takatz, 2007). In US, for example, Rule-based approach generated an overflow of useless information with all financial institutions reporting almost everything (Pieth and Aiolfi, 2003). This inefficiency contributed to the idea that AML frameworks are inefficient fighting against organized crime (Naylor, 2002). Despite the criticism, some authors argue that with rule-based system rules are clear and transparent providing legal certainty and equally to the system (Unger and Waarden, 2009).

Cooperation in rule-based approach is passive and static. Agents are only concerned in following the rules but they are not required to have critical opinion. Hence,

lots of legal operations are reported because there is no sensibility to understand the risks. With the False-Negative system of fines – agents are fined only if they do not report an illegal transaction – there is an incentive to report everything clogging the AML system. It is the Crying Wolf effect (Takatz, 2007). Over-reporting also has another advantage for non-cooperative agents. Since the system are not prepare to receive too many reports, reporting everything is like doing no report at all, since the illegal transactions will be diluted in the middle of thousands of fake suspicious (Unger and Waarden, 2009). Moreover, risky operations which are not described on law are not reported. Money launderers study these gaps and mislead AML systems (Pellegrina and Masciaro, 2008).

Risk-based approach is different. The system relies on the principle that regulations should be strong whenever the risks are greater (Hutter, 2005). The agility of the system means fewer costs and less bureaucracy and other administrative burdens. Nevertheless, it is necessary a serious assessment of the risks which obliges AML frameworks to have experts and more regulation and supervisory than in the rule-based approach. With this system, AML framework is putting the responsibilities of monitoring to those agents (mainly banks) which really understand the transactions. Still, the authors observe some problems too. They recognize that banks are unable to monitor all operations. Inefficiencies caused by double risk assessment (in the first level banks and authorities after) or conflict of interests between monitor obligations and commercial objectives of the bank are some major inconveniences (Unger and Waarden, 2009). Other opinions noticed sooner that risk-based approach “makes the obligation of public authorities passive: in this model they await reports from bank managers, accountants, lawyers and other professionals, rather than taking active steps to deploy crime-fighters to identify, pursue and indict criminals” (Mather, 2001). Non-cooperative institutions can also use Risk-based approach to do not reporting some clients or activities in particular, generating erratic reporting and lack of homogeneity. Similarly to Rule-based approach, Crying Wolf effect also exists here. Banks and auditors have information about their clients that they do not want to share. The agency problem created by that generates asymmetry of information potentiating Crying Wolf behaviors (Takatz, 2007).

Risk-based approach arose with the Third Directive of EU (ACAMS, 2010). The new responsibilities of financial institutions oblige them to improve their Risk Management departments since they are required to create internal structures of compliance and report. The capacity to judge and process information requires the allocation of financial institutions' expertise in these areas (FAFT, 2007).

## 2.3 Anti-Money Laundering Criticism

Despite of being reasonably consensual, AML systems have been criticized for their economic inefficiency. The following paragraphs indicate the main weaknesses point out by different authors.

- **Cost-Benefit Analysis**

In order to evaluate AML Framework in economic terms, the costs of these policies have to be compared with their benefits. Considering that resources are always limited, governments should decide their level of expenditures and resources allocation seeking for the greatest benefit possible (Mitchell, 2005).

AML frameworks, in particular when focused on the process, rather than the results, are not cost-efficient (Mitchell, 2003). Different authors have stressed some important costs associated with AML Frameworks which beside the direct costs, also promote collateral damages with undesired side effects to the legal economy (Geiger and Wuensch, 2006).

Direct costs related with AML laws have tripled in US, in the last 20 years, while costs related with prevention quadrupled. However, the total amount intersected is only near 700 million \$US (Reuter and Truman, 2004). This is not a pretty good result according to Interpol, which states that 3 billion \$US of dirty money has been seized in 20 years. Some authors also indicate that the percentage of failures of current AML framework is 99,9% (Komisar, 2003).

Regarding indirect costs, Compliance Departments and Risk Management structures are examples of costs supported by financial institutions with market capacity to launch these costs directly in the final consumer (The Economist, 2002). Moreover, these additional costs forces financial institutions to adopt an antagonist relationship with their customers (Barr, 2003). These costs are obviously supported by every client and not only by the criminals, constituting an incentive to the cooling of licit activities too. Observing carefully the phenomenon, those clients who perform licit activities do not have the higher returns of illegal activities. As a consequence, illegal activities are still quite profitable while legal ones could be or not (Geiger and Wuensch, 2006). The proof that

crime remains profitable is that underlying crimes such as drug trafficking and organized crime have come to prosper in the last years (Schneider and Enste, 2000).

From the managerial point of view, bank's investments in compliance aimed at managing reputational risk. This is a trade-off where bigger banks are able to do not take risks while smaller institutions have an incentive to engage in riskier commercial relations (Butler and Ribstein, 2006). In economic terms, others authors believe that AML Frameworks have perverse effects in economic performance (Cavalcante and Andrade, 2006).

Finally, the fight against ML is not a fight against crime, at least directly. Instead of fighting crime, AML Frameworks only prevent the launder process. In other words, it reduces the expected profitability of crime (see Annex 2). These efforts encourage the concentration of dirty money used to commit more crimes. AML Frameworks could be playing a role in the increment of criminal industry (Stancu and Rece, 2009).

- **The Paradox of Expected Punishment**

This paradox came from an empirical analysis which showed that higher probabilities of sanction and stiffer penalties do not play their dissuasive role as expected. The paradox means that higher frequency and severity applied to physical persons lead to higher – and not lower, as it could be expectable – levels of organized crime (Buscaglia, 2008). To explain this peculiar event, it could be useful to know the findings of Polinsky and Shavell where individuals, who in general are risk averse, behave as risk neutral inside a criminal organization (Polinsky and Shavell, 1979).

- **Pervert effects in Social Welfare (Hypothesis)**

Concluding the section about AML criticism it would be useful to get some insight about some other studies which argue that AML can jeopardize general welfare. One of them states that in countries where organized crime is pretty entrenched, a stricter policy can reduce the social welfare since these two hard positions (authorities and criminals) will fight to decide who is tougher and frightful, imposing a climate of war and reducing the social welfare (Garoupa, 1997). Other concern the increase of transaction costs associated to the implementation of AML Frameworks. If costs of compliance rise too much, transaction costs are going to be prohibitively high, increasing the competitive edge of black markets. Then, black markets will increase until a certain level, where they will start assimilating resources from legal sphere (Geiger and Wuensch, 2006).

## 2.4 The Private Contribution: Compliance and Due Diligence

After discuss AML Frameworks from the governmental perspective, it is also interesting to go deeply in the private point of view.

Compliance is a mandatory cost for financial institutions since risk-based approach is in place. To evaluate the system, there is a constant requirement for compliance evaluation (FAFT, 2010) and authorities are determined to increment the compliance endeavor (Sen. Biden, 2008). The costs of compliance can be split into departmental costs (remuneration packages, office space, equipment or training among others) and indirect costs like time spent (opportunity cost) or number of transfers refused (when a deal with a counterparty is reject not in a commercial base but in a compliance base) (Mills, 2008).

Nevertheless, it seems there is a strong economic incentive into private sector to introduce compliance by themselves. Business ethics pays in the long run (Stückelberger, 2007) and compliance is a good way to enforce ethics in firms operations (Jones and Bingham, 2009).

Some Risk Management specialists point out several different areas where Due Diligence should be in order to build an effective Corporate Compliance strategy (Mills, 2011). Know Your Customer policies, Training or Monitoring and Reporting are some of them.

- **Know Your Customers Proceeds**

Know Your Customer (KYC) initiative was considered a critical element in fighting ML by Basel Committee. KYC procedures aiming to keep recorded and updated information about customers. Inculcating KYC procedures in financial institutions' operations will help them dealing with reputational, legal, concentration and operational risks. To do it, KYC programmes should connect some different aspects. Defining a clear Customer Acceptance Policy, Reinforce Customer Identification and establish an On-going Monitoring are the core aspects (Basel Committee 2001). Customer Acceptance Policy is particular important in internet banking where non face-to-face persons do their banking operations (Suh and Han, 2002).

- **Training and Monitoring**

Nowadays, Training is essential to perform AML procedures like Monitoring or Reporting. Furthermore, it seems to be the most cost-effective method since it enriches Human Capital giving to them the necessary code of behavior and awareness towards ML schemes (Kidman, 2006). From Economics, we know that economies of experience influence positively the reduction of costs (Hax and Majluf, 1982).

Monitoring is also another important duty of financial institutions which impacts in their profitability since it is an important tool to manage risk (Picard and Pieretti, 2010). Besides that, doing the right monitoring is an essential task to be considered as a cooperative jurisdiction (FAFT 2003).

- **Risk Management**

Traditionally, there are some doubts about the efficiency of Compliance Departments. They are seen as blockers of the commercial activities or at least, cost inefficient from the corporate point of view (Nijssen et al, 2008).

Nonetheless, compliance monitors the activity reducing its operational risk (Basel Committee 2001), as well as, the presence of a Compliance Department changes the culture of institutions generating an ethical environment with fine consequences in reputation. Additionally, it builds confidence. In fact, as Alan Greenspan said “Our reputation is our only asset – without it we worthless” (Larkin, 2003). In this sense, compliance works as a reputational shield.

Lastly, Legal risk is also mitigated by compliance. In an economy ruled by risk-based approach, compliance is vital to assess in what dimensions should companies be exposed, and what levels of risk should be taken in variables such as policy risk or litigation risk (Moeller, 2007).

### **3. Countries Comparison**

#### **3.1 Social Comparison**

In order to perform a social comparison between Portugal and UK, several indicators will be used. Considering the results of Hofstede Index (see Annex 3), Portugal can be defined, in comparison to UK, as a more cooperative society where people are more

community oriented than in UK. Gender discriminations are more likely to occur in UK or at least, people does not perceive as so shocking the observation of these discriminations. The extremely high value presented by Portugal regarding Uncertainty Avoidance means that Portugal tends to have a lack of entrepreneurship and people really care about stability. In UK, the risks are more accepted. Lastly, Portuguese society agrees reasonably with the disparity rather than British who do not tolerate them very much.

Politically, it would be useful to take a look into some other phenomena such as corruption. Corruption is particular important since it affects the way states work and consequently, the effectiveness of AML Frameworks (Becker and Stigler, 1974). Unfortunately, corruption is also tricky to evaluate and control (Elliott, 1997).

Through the Corruption Perception Index it can be establish a proxy for the phenomenon. According to that index, UK is a relatively clean country with a degree of transparency of 7.6 in a scale of 1 to 10 where the cleaner country gets a 9.3. Portugal is not so well positioned with a value of 6 (Transparency International, 2010).

### **3.2 Legal Comparison**

The Portuguese law has tended to be in line with the international standards of EU and UN (FAFT, 2006). Since the second EU directive and FAFT recommendations, AML Frameworks are based in an international cooperation among cooperative countries (EU, 2001)<sup>3</sup>. The revision of Penal Code was also important to enlarge the competencies of the law against legal persons. Before the revision of Penal Code, legal persons were not criminally liable for ML (FAFT, 2006). However, with law n<sup>o</sup>25/2008, the criminal liability was extended to a vast range of legal persons (Law n<sup>o</sup>25/2008)<sup>4</sup>.

Regarding UK, British AML Framework is in line with the Third EU Money Laundering Directive and UN Conventions (FAFT, 2007). Furthermore, UK has a defined strategy since October 2004 against ML: the Government's Anti-Money Laundering Strategy (HM Treasury, 2004).

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<sup>3</sup> See PDF Version of the European Directive in: <http://www.fd.uc.pt/CI/CEE/pm/LegCE/CE-Directiva%202001-97.pdf> [accessed 16 May 2011]

<sup>4</sup> See PDF Version of Law n<sup>o</sup>25/2008 in: [http://www.bportugal.pt/en-US/Supervisao/SupervisaoPrudencial/BranqueamentoCapitaisFinanciamentoTerrorismo/Documents/Law25\\_2008\\_EN.pdf](http://www.bportugal.pt/en-US/Supervisao/SupervisaoPrudencial/BranqueamentoCapitaisFinanciamentoTerrorismo/Documents/Law25_2008_EN.pdf) [accessed 16 May 2011]

The law which criminalizes ML offences is the Proceeds of Crime Act (POCA) of 2002. The concealing, arrangement or acquisition of criminal properties is considered illicit from the UK's legislation. Moreover, it is also considered a crime whenever any identity does not report a suspicious transaction (Proceeds of Crime Act, 2002)<sup>5</sup>. This is consistent with the EU system of "false-negative" fines (Pellegrina and Masciaro, 2008). The position of the suspects in the ML process (facilitator or beneficiary) is not important because POCA applies to "a person" which means that there is no qualification regarding the role that each person plays on the process (Proceeds of Crime Act, 2002)<sup>6</sup>. This law was reinforced with Serious Crime Act of 2007 which focus on the role of the law in the prevention of serious crimes (Serious Crime Act, 2007)<sup>7</sup>.

In order to prove that the property in question is a criminal property, British law exempts the obtainment of unequivocal evidence. To obtain a conviction for a predicate offence, circumstantial evidences can just rely upon a combination of factors such as the lifestyle of defendants, the financial expert evidence of suspicious transactions or the manner in which the property is disposed (FAFT, 2007).

The most important difference between Portugal and UK's legal system is the fundamental way in which each country makes and applies law. UK, with the exception of Scotland which has a hybrid system, applies Common Law Principles (FAFT, 2007) whereas Portugal follows the Civil Law Principles. In Portugal there is a clear tendency to codified law according to the *latin codex* which generates an heavy amount of codes and norms (Vicente, 2010). In UK, Common Law allows courts to make law. The law is judge-made and the Risk-based approach is a tradition in British legislation. The capability of judges to make law leads other courts to follow the same jurisprudence in order to keep the equity among decisions. Codification is fewer because the law is developed according to the courts decisions, but at the same time, it is more likely to set certain injustices as laws (Slapper and Kelly, 2009). Some typical standards are found as law in UK such as the standard of "due diligence" or "fiduciary duty", but the specification of these terms only occurs when courts apply them in concrete cases (Unger and Waarden, 2009).

In terms of law enforcement and prosecution authorities, in Portugal, Public Prosecution is the unique entity with power to initiate criminal proceedings. It enjoys full

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<sup>5</sup> See Proceeds of Crime Act (2002) in: <http://www.legislation.gov.uk/ukpga/2002/29/contents> [accessed 16 May 2011]

<sup>6</sup> See Proceeds of Crime Act (2002) in: <http://www.legislation.gov.uk/ukpga/2002/29/contents> [accessed 16 May 2011]

<sup>7</sup> See PDF version of Serious Crime Act (2007) in: [http://www.legislation.gov.uk/ukpga/2007/27/pdfs/ukpga\\_20070027\\_en.pdf](http://www.legislation.gov.uk/ukpga/2007/27/pdfs/ukpga_20070027_en.pdf) [accessed 16 May 2011]

autonomy and oversees the investigations of criminal policy. At the same time, Public Prosecution receives complaints and denunciations. Inside Public Prosecution there are several departments. In annex there is a simplified architecture explaining the functioning of Portuguese system (see Annex 4). In the British case, Home Office is responsible for the national security and then, UK has four different Prosecution bodies. In the field, Serious Organized Crime Agency (SOCA) executes Prosecution instructions, and in financial crimes, Assets Recovery Agency (ARA) can also intervene. In annex there is also a simplified architecture explaining the functioning of British system (see Annex 5).

Regarding supervision, Portuguese and British models are quite similar. In fact, Supervisors have analogous powers and responsibilities. The biggest difference is that in UK, the system promotes the debate between legal authorities and economic agents, while in Portugal this is not so clear, at least in the Framework (see Annex 6). The cooperation between public and private bodies in UK have generated a sort of private associations which have already took some voluntary steps towards self-regulation in order to mitigate reputational risks (see Annex 7).

Considering the status of implementation of FAFT-GAFI Recommendations, both countries are cooperative despite presenting some faults (see Annex 8).

## **4. Economic Impacts of Money Laundering**

Now, after the summary of the differences between Portugal and UK, it is time to observe some economic models applicable to this issue.

### **4.1 Economic Models**

There is always an incentive to commit a crime. On the other hand, society defends itself through the imposition of punishments. Between these two forces, there is a choice, or in other words, an economic trade-off. Jeremy Bentham, a British philosopher was the first scholar indicating these two forces. “The profit of the crime is the force which urges man to delinquency. The pain of the punishment is the force employed to restrain him from it. If the first of these forces be the greater, the crime will be committed” (Bentham, 1780). Based on this preliminary analysis, some economists translated the problem of

crime to economic terms. Their contributions will be used during Hypothesis discussion, later on (see Annex 2).

## 4.2 Sensible Variables

Generally, each model stresses some variables and draws conclusions to others. Before answer the Research Questions, it could be useful to know more about some of these variables.

- **Corruption**

The perceived level of corruption is a very important variable to study ML because corruption affects both the propensity to fight ML and the effectiveness of judicial system. Not surprisingly, the prevalence of ML increases in more corrupted countries (Kaufmann, 2004). This observation is confirmed by an econometrical work from Universidade de Brasília where estimated regressions showed that less corrupt countries are more likely to implement an AML Framework. In the same study it is pointed out also that the simple existence of any AML Framework enhances the perception of transparency or less corruption (Cavalcante and Andrade, 2006).

Corruption is also a weakening factor of legal system and its deterrence capacity (Bowles and Garoupa, 1997). These phenomena are particularly interesting for criminal organizations since they are able to engage on corruption big structures, rather than individuals, benefiting from economies of scale (Garoupa, 1997).

- **Foreign Direct Investment**

Foreign Direct Investment (FDI) is important to any country. It is a boosting factor for economies. Nonetheless, part of FDI comes from illegal proceeds and it has illegal motives. Some investments are done, not to follow the higher returns to the same risk level, but to simply facilitate tax evasion or disguise illegal origins of the money (Reuter and Truman, 2004). Nowadays, the existing technologies allow investors to easily order capital flights with less transaction cost than ever. Furthermore, the amount of dirty money involved is generally huge becoming impossible to launder it locally (Brada et al, 2009). To avoid detection, the creation of a web of bank accounts, typologically and geographically dispersed, using surrogates and false identities, is regularly the preferred method (Buchanan, 2004).

FDI is also a phenomenon usually related with corruption, even for legal FDI. Some authors see corruption as a source of instability and risk, therefore the presence of corruption is an incentive to capital flight generating FDI (Kant, 2002). Other authors argue that FDI flows can be influenced by the level of corruption in both, home and host country (Drabek and Payne, 2002). However, this relation is not so clear. The relation between corruption in host countries and FDI seems to be more related with other host conditions such as the clearness of laws applied to foreigners (namely related with property rights), or political stability (Brada et al, 2009). Basically, in this last case, the amount of FDI is a signal of quality of institutions in host country (Al-Sadig, 2009).

- **Dimension of Shadow Economy**

Shadow Economy consists in all trades of goods and services that are not legal or performed legally. Informality in economy is not confined to a specific sector of economic activity but rather cuts across many sectors (Becker, 2004). Obviously, the persistence of shadow economies, in parallel with the legal ones, prevent the accuracy of macroeconomic policies since statistics do not capture the entire reality, but only the legal side of it. Additionally, the existence of shadow economies is a deviation of resources from the legal economy. On the other hand, two thirds of the income generated in shadow economies is spent in the legal economy stimulating it (Schneider, 2002).

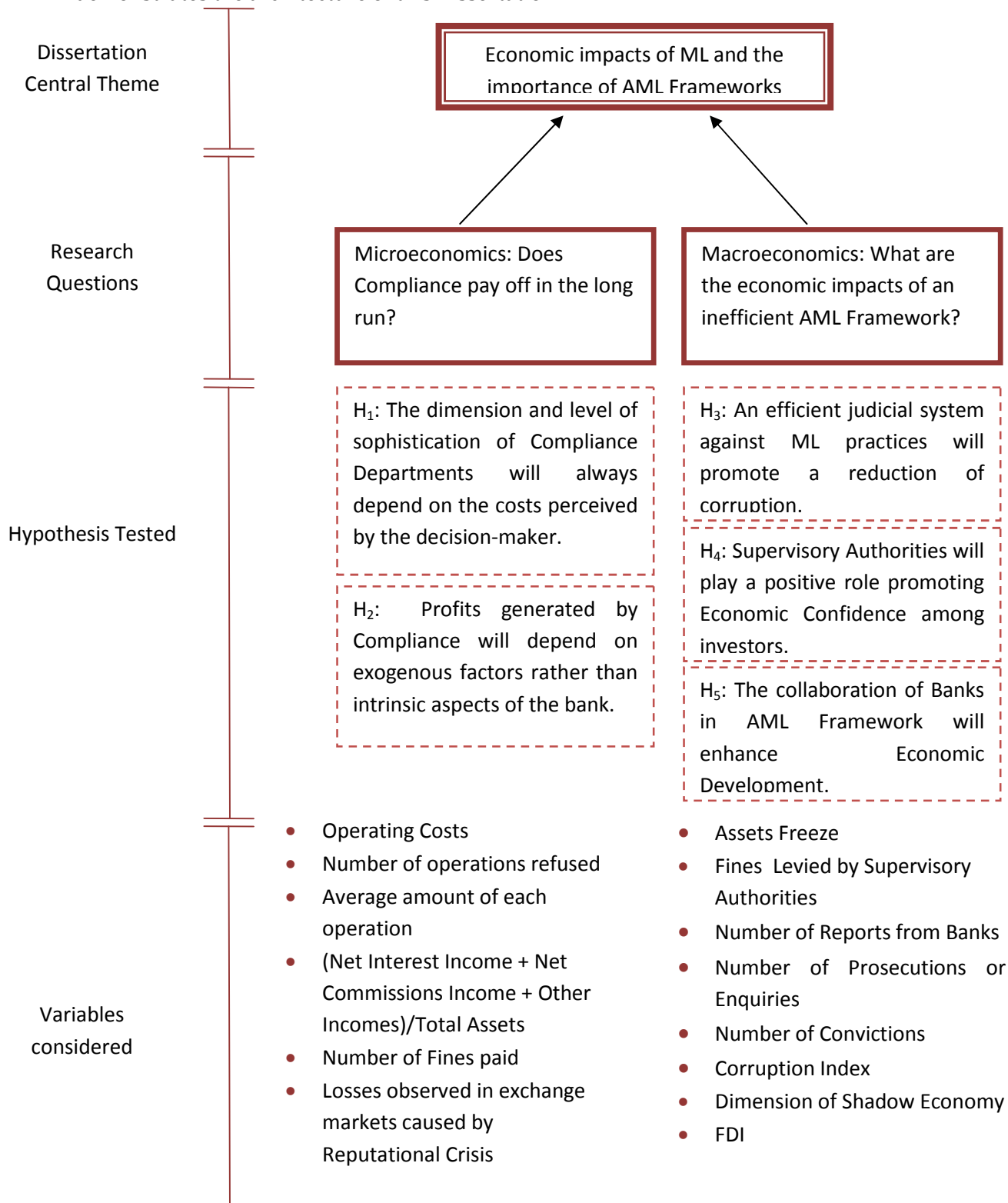
Shadow economy exists because it is more profitable, sometimes because it simply does not pay taxes and social contributions (Thomas, 2002). However, the resistance of the phenomenon is driven by other factors. What is known is that “once this habit is developed, it is unlikely that it will be abandoned...” (Spiro, 1993). In this sense, governments should be interested in making shadow economy less attractive through a reduction of taxes but mainly, through a tough application of penalties (Cebula, 1997). Notice that this reduction in taxes could result in an increase of total fiscal revenues following the principles of the Laffer curve (Lemieux et al, 1994).

Lastly, empirical evidence supports the idea in which more regulated countries tend to have a higher percentage of shadow economy in comparison with the legal ones (Johnson et al, 1997).

### III. Methodology and Data Collection

#### 1. Conceptual Framework and Research Questions

Before presenting Methodology used and Data Collected, the following scheme demonstrates the architecture of this Dissertation.



Now, in order to validate the Hypothesis and draw conclusions, this chapter will be divided into Methodology and Data Collection, explaining what were the steps carried out to perform the study, its validity and how was collected the data.

## **2. Methodology**

This Dissertation is an exploratory comparison of Portuguese and British realities. Portugal was selected for being the home country of the author and the country where the study was prepared. The comparison with UK had in mind two different aspects. The first one was the different legal system in place in Anglo-Saxon countries, based on Common Law, instead of Civil and codified Law of Latin countries. The other aspect was that UK presents a different economic reality when compared with Portugal, having a historical financial hub and mature Compliance principles.

To perform this study it was used both descriptive and comparative analysis. Comparative analysis was based on values collected in annual reports from public authorities such as SOCA, international evaluations from FAFT-GAFI, annual reports from banks, economic journals, institutional websites like UNCTAD and academic papers. Data gathered through these sources was filtered in order to be used to answer Research Questions and Hypothesis posed in this Dissertation.

Furthermore, it was made some interviews among Compliance Departments of Portuguese banks. These interviews had a common Interview Guide following the in-depth interview technique, which intends to acquire a broad perspective of topics according to the point of view of respondents (Mack et al, 2005). Thus, the author wanted to get a full picture of the respondents' perspective in order to increase the volume of data available to carry out additional comparisons. Interviews were useful to orient the study, particularly regarding the potential profits which are perceived by Compliance Departments. In this sense, Legal and Reputational risks, for example, were variables that the author incorporates in this Dissertation only after hearing the main concerns of respondents.

Notice that, the fact of having the same Interview Guide to all interviews helps to guarantee the reliability of the study. Moreover, reliability is also guarantee through the confrontation of data collected with official documents from public and private bodies such as FAFT-GAFI Reports and Annual Reports from banks.

Besides that, the analysis of hypothesis also followed some principles of a descriptive analysis. With this another perspective, this Dissertation aims to interpret the

information collected and establish some possible relations with the theoretical topics discussed during Literature Review. Thus, the discussion of Hypothesis always tried to go beyond the comparison between the two countries to advance to a general explanation or interpretation of the general reality which is being studied (Coffey, 1996).

Regarding Validity, this dissertation tried to ensure the internal validity of its conclusions. Internal Validity means that the study is able to answer Research Questions posed using the variables which are analyzed in the study (Campbell and Stanley, 1966). In fact, Research Questions have a sort of variables associated (see Conceptual Framework above) which were collected and analyze to answer them.

### **3. Data Collection**

Data collected in this dissertation comes from different sources, however, during the collection process, the author only focused on Banks. Other Financial Institutions such as Insurance companies or all non-financial sectors were excluded. This decision regarding the scope of analysis was taken to preserve the coherence of the analysis. First of all, due to the fact that interviews were done only in banks. Secondly, due to the lack of implementation of AML Frameworks in non-financial industries in Portugal and lastly because statistics show that both in Portugal and UK, relevant steps carried out against ML offences have been done in Bank industry, more than in any other sector.

#### **3.1 Choosing Data: Underlying Reasoning**

In order to assess the key factors involved in the first Research Question, it will be necessary to guesstimate previously, some important expenses and profits caused by Compliance Departments.

Regarding costs, there are two different types of costs considered. The direct costs associated with the operation tasks, and secondly, the opportunity cost. Opportunity costs are crucial expenses of any Compliance Department that cannot be hidden otherwise the cost-benefit decision could be oversized. In this case, opportunity costs are all the profits which would be generated by the bank operations that Compliance Department rejected, preventing them.

Then, the costs considered to validate first Hypothesis were the following:

**(1)** Direct costs + Opportunity costs  $\Leftrightarrow$  Operating costs + [(N<sup>o</sup> operation refused x average amount x ((Net Interest Income + Net Commissions Income + Other Incomes)/Total Assets))]

Notice that ((Net Interest Income + Net Commissions Income + Other Incomes)/Total Assets)) is a proxy to a rate of return of each monetary unit existing on the bank.

Concerning profits, which is important to the second Hypothesis, despite having no cash flows associated with current activity, compliance generates two potential types of gains. The first one, which is more obvious, is the money saved in fines levied by supervisors that are prevent through the application of compliance norms. Methodologically, to estimate this potential profit, it was compared the British and Portuguese reality about the number of fines imposed by supervisors related with ML offenses. The second potential gain is the reduction of Reputational Risk. To assess the impact of reputational crisis in share prices of banks, it was projected the potential loss caused by this type of problems in both exchange markets, London and Lisbon. To do this, it was considered some examples of reputational crisis in British and Portuguese banks and observed share price's behavior during the critical period.

So, the potential gains provided by Compliance Departments can be expressed by the following expression:

**(2)** Value saved on Fines + Mitigation of Reputational Risk  $\Leftrightarrow$  N<sup>o</sup> of Fines paid + Losses observed in exchange markets caused by Reputational Crisis

To answer the second Research Question it would be necessary to appraise some indicators related with the efficiency of courts and police enforcement. These items, such as the *amount of assets frozen* or the *number of enquiries and convictions*, will be used as indicators to describe the efficiency of AML Frameworks, both in Portugal and UK. Additionally, the *number of reports* received by SOCA and Portuguese FIU will also be analyzed. Actually, the higher number of reports means a higher degree of private engagement fighting ML. Finally, *fines levied* by supervision entities will also be considered since supervisory activity also influence the way financial institutions behave.

### **3.2 Sources of information**

As it was referred above, in Methodology, this Dissertation had some concerns in relation to the sources used and its veracity. To handle this problem it was used official data and statistics released by public and international authorities. In few occasions, it was also used data from previous studies and journals. During interviews, it was respect all ethical guidelines, as they are stated at the beginning of Interview Guideline. In Appendixes section, there is a resume table with the data used to discuss each hypothesis (see Appendix 1).

### **3.3 Data Collected**

All Data Collected is presented in a more schematic way in Appendixes, at the end of this Dissertation.

## IV. Data Analysis and Discussion

In order to understand some impacts of the issues referred in literature review, now this dissertation will focus on two different Research Questions. The first one tries to go further on the comprehension of financial institutions and their decisions about compliance. The main point is to know if financial institutions really have economic incentives to put in place costly compliance systems or if they simply adopt it in response to the law.

The second Research Question relies on macroeconomic indicators with the purpose of measuring or, at least, to estimate the impact of some variables dependent on AML Frameworks in other economic variables such as FDI, corruption or dimension of shadow economies.

### ***1. First Research Question: Microeconomics: Does Compliance pay off in the long run?***

In order to analyze the decision-making process of Financial Institutions, namely their compliance choices, it will be compared the costs and benefits of Compliance activities and observed in particular, differences in these costs and benefits for each country. The objective is to understand whether there are significant differences between Portuguese and British realities and how those differences can influence the final decisions of private bodies towards the way compliance works in both countries. Thus, this Research Question intends to understand if the existence of Compliance Departments in Portugal and UK, according to the different conditions of both countries, is only seen as a legal requirement and an outlay, or on the other hand, if it is based on a business-oriented decision focused on profits.

***H<sub>1</sub>: The dimension and level of sophistication of Compliance Departments will always depend on the costs perceived by the decision-maker.***

- **Data Analysis**

Considering the two variables for Portuguese and British cases (average dimension of Compliance Departments and their costs), it is possible to predict that the dimension of

Compliance Departments in UK is bigger than in Portugal. However, there is no evidence showing that British compliance is more sophisticated than Portuguese one. In fact, the answers collected in all interviews (see Appendix 2) denoted a different size between Portuguese and British departments, mainly in terms of Human Resources, but not in terms of technology and functionalities of IT employed. While the number of analysts working in Portuguese and British departments indicates a different scale, according to respondents, the degree of sophistication of IT is pretty the same as well as their functionalities and objectives. Regarding training methods and its expenditures it was impossible to achieve any conclusion.

Observing the number of reports sent by banks to Financial Investigation Units and Attorney General, utilized as a proxy to the number of commercial operations rejected (see Appendix 3), indicates that the different number of reports sent is proportional to the dimension of departments. This finding is curious. Notice that for British departments (on average with seven times more Human Resources than Portuguese ones), the number of reports is approximately seven times more too, meaning that the different amplitude of reports is equal to different amplitude of human resources applied.

Bearing in mind that one of the most important costs of compliance actuation is the opportunity cost, there are no big differences between Portuguese and British banks in terms of net interest and net commissions per unit of assets (see appendix 4). Thus, it is not expectable that opportunity cost impacts more or less on the dimension of Compliance Departments in one country or another.

- **Discussion**

Having said this, it is likely that the degree of exigency of the market assumes the most important role, driving the dimension of compliance, rather than the costs supported by banks with their departments. Therefore, the Hypothesis 1 seems to be rejected.

Based on the results extracted from interviews, the dimension of Human Resources, which explains the different dimension of departments, relies on the number of transactions monitored. Regarding IT, the systems of monitoring, filtering, Market Abuse applications, Risk Management software and lists of criminals/PEP's are pretty similar among European banks, even in different countries, thanks to the harmonization of the legal framework (see points 2.1 and 3.1 of Literature Review).

Moreover, Risk Management is a worthwhile tool to project the future. In economies where Risk-Based approach is the dominant mentality, which is the British

case (see point 3.2 of Literature Review), some authors, such as Moeller, argue that compliance plays an important role framing policy and litigation risks. This is another explanation to the bigger dimensions of Compliance Departments in UK.

In terms of costs, IT systems can vary (some banks acquired software externally, while others developed their own software in collaboration with Consultancy firms). Nevertheless, the initial cost appeared to be the biggest one. Then, banks support variable costs related with maintenance services or license payments. Licenses are very common in the case of external software. In these cases, banks pay a variable fee to use the systems. In other words, the total amount of fees depends directly on the use of the systems, with higher volume users paying bigger fees, despite some possible economies of scale. Lastly, there were no examples of outsourcing solutions registered during the interviews.

To conclude, there was no indication that the number of operations refused limits the size of Compliance Departments. In Data Analysis, nothing indicates that opportunity costs drive the private decisions about the size of Compliance Departments and during interviews, opportunity costs were always neglected when compared with direct ones. Hence, the dilemma between compliance and commercial goals, as Nijsen, Cavalcante and Andrade diagnosed in their works, does not seem to be important for the private decision-makers, probably because banks are able to replicate the costs of compliance directly on the clients and for bigger banks with bigger opportunity costs, there are also more clients to dilute these costs.

***H<sub>2</sub>: Profits generated by Compliance will depend on exogenous factors rather than intrinsic aspects of the bank.***

- **Data Analysis**

According to what is referred in previous section, Methodology and Data Collection, the profits identified to verify this Hypothesis are the value saved in fines and the mitigation of Reputational Risk. These two aspects meet the two essential concerns of banks according to the answers collected during the interviews: legal costs and Reputational Risk. Unfortunately, these are two potential profits that cannot be quantifiable because they are not cash flow. Nevertheless, the probability of occurrence is a good measure of the risk and consequently, the mitigation of risk achieved through the compliance procedures.

Then, to estimate the legal costs it was observed the number of fines levied by supervisors regarding ML/FT events in Portugal and UK (see Appendix 5). The results showed a big disparity between the two countries. In UK, fines are relatively common, while in Portugal there are no fines registered to the same period.

Reputational Risk in Portugal and UK was estimated based on some examples of reputational crisis happened in national banks of the two countries. The periods of crisis are usually accompanied by sharp falls in share prices. Confronting the historical devaluations in Portugal and UK, the conclusion is that Portuguese and British investors have a completely different approach towards reputational crisis. While in UK reputational crisis really damage the equity value of shareholders, in Portugal the devaluation is smoother (see Appendix 6).

Notice that these differences between Portuguese and British environment shows that the risks are quite much higher in UK and consequently, the potential gains of Compliance Departments are higher too.

- **Discussion**

Through Data Analysis, there are recognizable bigger differences between Portuguese and British environment. These differences affect directly the potential gains perceived by managers in relation to Compliance Departments. Moreover, the two variables analyzed were the ones identified by respondents during the interviews as the most important (legal costs and Reputational issues), therefore, second Hypothesis seems to be accepted.

With respect to profits, compliance seems to be a non-profit activity. However, compliance is crucial to reinforce the structure and the safety of the banks, as Bramwell, Picard and Pieretti wrote. Based on that, money saved on fines applied by courts and supervisors, which apparently seems to be the biggest gain from compliance, probably it is not. As Greenspan said, reputation is the main asset of Financial Institutions. Thus, the most important aspect of compliance is the reduction of Reputational Risk, obtained through a strategic increment of compliance policies. Like Larkin said, compliance is the hedge against Reputational risks. This aspect was stressed by respondents in interviews.

Based on results extracted from data collected, the degree of exigency towards transparency and legality is bigger in UK. Other explanation to the same remark is the superior level of literacy of British investors, meaning that they are more able to recognize risks.

Considering all these aspects, there are two big conclusions that should be taken. The first one is that managers should recognize the strategic importance of compliance mitigating risks and projecting a better future. The second relies on the fact that in most risky environments (where markets are more exigent and law enforcement is more tight) compliance delivers higher potential gains.

- **Conclusion and answer**

According to the discussion of Hypothesis it is possible to conclude that Compliance pays in the long run. The size of departments seems to be related with the volume of operations and the strategic perspective that banks have over Legal and Reputational Risks. Furthermore, profits of compliance depend on exogenous factors like law enforcement or the degree of exigency of investors. Thus, perceived profitability of Compliance Departments depends on the country where banks are operating. In fact, each country, with the application of its laws and the particular sensibility of its exchange markets, sets a certain level of economic incentives to compliance. These conclusions reflect the profitability of transparency policies meeting some other previous arguments (see point 2.4 of Literature Review) from Jones, Bingham or Stückelberger, who argue something similar to this when they say that Business Ethics pays in the long run. Burkhold also defended that as markets start demanding integrity, companies should have an economic and strategic interest in compliance.

## **2. Second Research Question: Macroeconomics: *What are the economic impacts of an inefficient AML Framework?***

From the point of view of the political planners, it is particularly interesting to observe some data and establish some relations between the prevalence of some phenomena in society and the orientation and efficiency of political measures. As it was described before, launderers explore some countries' weaknesses in the legal, economic and political fields in order to execute their illicit activities. But ML is not only a consequence of these weaknesses. It also promotes them in a further stage. Therefore, it seems worthwhile to undertake some associations between the efficiency observed in national AML Frameworks and the political (Degree of Corruption, Status of Implementation of FAFT Recommendations), social (Quality of life and Cultural Traits) and

economic variables (FDI and Dimension of Shadow Economy). Then, it will be analyzed below, the Hypothesis presented in the Conceptual Framework.

***H<sub>3</sub>: An efficient judicial system against ML/FT practices will promote a reduction of corruption.***

- **Data Analysis**

According to the data gathered, the efficiency of justice in Portugal and UK is truly different. Actually, the number of enquiries and convictions in Portugal is quite low compared with UK. While the discrepancy in the number of enquiries (see Appendix 10) can be explained by the different dimension of the country and by the fact of UK being a financial hub with more financial transactions than Portugal, the number of convictions falls dramatically in Portuguese case, comparing with UK (see Appendix 11). Thus, the percentage of enquiries which results in convictions in Portugal is almost residual when compared with the British justice. Other aspect related with the efficiency of law enforcement is the amount of assets freeze. Here, Portugal has evolved and is presenting now a consistent amount of frozen assets, not really different from British values (see Appendix 7). Therefore, observing all components together, it is possible to admit that British judicial system is being more effective against ML/FT offenses than Portuguese system.

In terms of Perceived Corruption, UK is stated as being part of the group of the slightest corrupt countries. On the other hand, Portugal does not score really well in Corruption Perception Index, as it is indicated above, in Data Collection (see Appendix 15).

Both in judicial system indicators (such as asset frozen, number of enquiries or percentage of convictions) and Corruption Perception Index, values shows a great stability despite some positive or negative trends observed for example in Assets Frozen or Corruption Perception Index for Portuguese case.

- **Discussion**

Based on values studied previously, it seems that Hypothesis 1 can be accepted. In reality, accepting this Hypothesis meets the previous results already stated in Literature Review. As Kaufmann indicated, ML increases in more corrupted countries. Bowles and Garoupa observed that corruption is a key factor of deterioration of any legal system and its deterrence capacity (this theoretical remark is particularly in line with the results of Appendix 12). Additionally, Becker and Stigler had already found that corruption plays a

crucial role affecting the way public authorities work, with consequences to the law enforcement capacity.

Econometrical works from Cavalcante and Andrade also showed that less corrupt countries are more likely to implement quality AML Frameworks. In the same study it was stressed another finding related not with the corruption itself but with the perception of this corruption: the simple existence of any AML Framework in place diminish the perception of corruption, even when nothing happens to the genuine level of it.

#### ***H4: Supervisory Authorities will play a positive role promoting Economic Confidence among investors.***

- **Data Analysis**

Regarding Supervision, it seems to be more active in UK. In fact, after searching in different sources and entities, it was impossible to find any fine levied by Portuguese Authorities in relation to ML practices. In contrast, British Authorities play an active role punishing ML activities through the imposition of a considerable amount of fines (see Appendix 8). Notice that this observation is exclusively related with the punishment efforts and not about the prevention and regulation aspects.

At the same time, UK seems to have a more vigorous economic performance attracting FDI. The results are consistent to the years verified through the data collected (see Table 12) which means that UK is more capable to both attract foreign investors and keep the resources generated internally within the country. The Portuguese results for 2002 and 2003 show another curious fact: FDI from foreign equity is bigger than the total FDI which means that in these years, the stock of reinvested earnings were negative. In other words, the profits generated by foreign capital were withdrawn from the country to be reinvested in another place. This did not happen in British case revealing a different attitude of foreign investors towards UK, more confident in the British economy.

- **Discussion**

According to the values collected, this Hypothesis seems to be accepted, meaning that there is a positive relation between the degree of intervention of Supervision and the confidence of foreign investors. As supervision is responsible for the regulation of the market, an active supervision is important to offer a transparent image to the possible investors. This aspect became particularly significant after the crisis, as Warren and

Bradley among others, express in their articles. Moreover, Bartlett observed that in financial system, the confidence is more than important, it is the main asset of the market.

Not surprisingly, the conditions provided by host countries directly impact on FDI volumes, as Brada defends in his article. Therefore, it is likely that supervision participates in FDI results as a provider of quality and reliability to the system. According to Al-Sadig, the amounts of FDI can be even observed as signals of the quality of institutions.

Finally, the risk-based approach undertaken by British authorities also compelled supervisory to assess the risks in a more proactive way. According to Hutter, this posture provided more transparency, modernization of governance and less bureaucracy to the economy. These are values that foreign investors seek. On the other hand, Reuter, Truman and Takatz observed, in different articles, that Rule-Based approach gave consistently lower outcomes when compared with Risk-Based approach applied to AML Frameworks. Pellegrina and Masciandaro also referred that a Rule-Based approach is fallible since criminals can study the rule and deceive it. This can be another explanation to the absence of fees in Portuguese reality.

### ***H<sub>5</sub>: The collaboration of Banks in AM Framework will enhance Economic Development.***

- **Data Analysis**

The collaboration of financial institutions with public entities, in particular with investigation authorities, can be accessed through the analysis of the number of suspicious reports sent to FIU's and Attorney General. What can be observed again is a complete disproportion between Portugal and UK (see Appendix 9). Obviously, part of this disparity relies on the fact that Portuguese banks being fewer and smaller than British ones, which has consequences in the total number of operations carried out. However, observing the evolution of Portugal in the last three years, it is possible to argue that Portugal is increasing the volume of reports (reports almost double between 2008 and 2010) due to a high margin to improve that Portugal has to deplete yet. Then, the extent of disparity between the two countries reveals a different scope (UK has 10 and 7 times more reports from banks than Portugal in 2009 and 2010 respectively) that cannot be seen only as a consequence of a different dimension of bank industry but probably as a sort of inefficiencies in communication/cooperation between private bodies and authorities.

Regarding economic performance, it would be worthwhile the analysis of FDI, as well as the estimates about the approximate dimension of Informal Economy in each

country. In relation to FDI, the analysis is the same did above, for the forth Hypothesis. Considering Informal Economies, the estimations indicate that Portugal has a bigger Informal Economy (in percentage of GNP) than UK (see Appendix 13). The difference is bigger (around 10%), which situates Portugal in the group of countries with bigger parallel economies, and on the opposite side, UK as one of the “cleaner” countries in relation to the absence of Shadow Economies. Considering the unweighted averages over selected OECD countries for the same periods, statistics indicates that Portugal has a bigger incidence of Parallel Economy than the average, while UK is a “good example” with a smaller Informal Economy.

- **Discussion**

Through the variables considered in this Hypothesis, it is possible to conclude that there is a positive relation between the number of reports send by banks to the public authorities with competency to investigate ML/FT practices and the dimension of Parallel Economy in each country. In the same direction, FDI flows are also stronger in UK, where the collaboration of Financial Institutions with authorities is bigger. Moreover, the amplitude of the disparity observed in all variables (the differences are huge in all three indicators: Number of reports, FDI flows and Dimension of Informal Economy) also seems to confirm that Hypothesis 5 is correct, stating that Economic Development is positively influenced by the collaboration between banks and investigation units.

As it was described above, the existence of Parallel Economies damage the real economy since they prevent Governments to portray the accurate scenario of the macroeconomic conditions. Moreover, these illegal activities are a source of tax evasion. Nevertheless, some studies, like what Schneider did in 2002, argue that two thirds of the income generated in Parallel Economies is spent in legal activities, stimulating them. Although the appearance of Parallel Economies are motivated by high taxes and social contributions, as Thomas argued in his handbook of 2002, the persistence of the phenomenon is explained by other characteristics. In 1993, Spiro defended that the continuation of high levels of shadow activities is caused by cultural habits. Applied in this case, the idea would mean that Portuguese culture would tend to illegal activities, more than British one. However, in 1997, Cebula indicate that coercive power and the severity of the punishment will decrease the volume of illegal transactions. This argument seems more consistent with Data collected. According to Cebula’s reasoning, Portugal would have more shadow activities due to the lack of efficiency of justice, which in fact could be true, considering the lower number of reports sent by banks to investigation authorities.

Basically, this is the application of Masciandaro Model described in Literature Review, where the expected utility of the illegal activity also depend on the probability of being caught.

Another aspect that should be taken in consideration is the “type” of FDI which can be attracted by each country. As Reuter and Truman pointed out, part of FDI flows comes from illegal activities, and tends to be placed in countries that cannot detect them. Therefore, and according to this perspective, there is a possibility of having a higher percentage of “dirty” FDI in Portugal than in UK, considering that financial institutions seems to be less cooperative with authorities in Portugal (fewer reports sent).

Finally, the difference between Portuguese and British legal system can be behind these results. The British Risk-based approach, together with the False-Negative system of fines, obliges Financial Institutions to be extremely careful in their monitoring processes. As Unger and Waarden identified, Risk-based approach generated more vague criteria. In conjunction with the False-Negative system of fines (banks are only fined per each illegal transaction that they do not report), introduced by Proceeds of Crime Act of 2002, Financial Institutions feel more comfortable reporting almost everything. Therefore, the huge volume of reports identified for UK can be, not a signal of quality and rigor, but a consequence of the Crying Wolf effect recognized by Takatz in 2007. However, the Portuguese Rule-based approach is not safe from the Crying Wolf effect. Pieth and Aiolfi, in 2003, observed that Rule-based approach systems tend to generated an overflow of useless reports, and Johnson in 1997 carried out an empirical study showing that more regulated systems tend to coexist with bigger Parallel Economies.

- **Conclusion and answer**

After accepting the three hypotheses, it is possible to argue that an efficient AML Framework have a positive effect on Economy, minimizing corruption, enhancing the perception of transparency and confidence in the economy, stimulating FDI, reducing Parallel Economies and consequently, increasing the tax revenues collected by governments.

## V. Conclusions

In conclusion, ML is a global phenomenon with social, political and economic consequences which requires global answers and broad perspectives to be defeated (see Annex 9). Having this in consideration, it is clear that ML flows threat civil society and private bodies.

Some years ago, Financial Institutions start creating Compliance Department to handle this issue, not only due to legal obligations, but also because Legal and Reputational Risks threat corporations as a whole. Furthermore, compliance seems to provide stability to financial balances and it is taking part of the sustainable and transparent image that Financial Institutions must develop nowadays. Therefore, a conscientious and broad vision of any business ought to consider compliance as an important tool in the strategy of the company. Notice that beyond the current benefits, compliance can be explored has a source of competitive advantage, considering that financial markets are troubled, increasing the premium for solid and transparent brands.

Reputation is something that is hard to build, but it is much easier to destroy. So, compliance should be strategically design to perform its operating tasks, but also to promote the image of the company and be proactive creating new ways of serving customers. KYC procedures for instance, can be used to improved customers databases and monitoring systems that can help industries to improve their efficiency and safety in a daily basis.

Other aspect regarding private decisions towards compliance is the importance that environment has in defining the potential gains of Compliance Departments. According to conclusions extract form this Dissertation, markets where transparency is more valuable can increase the pressure of private sector to go further in compliance.

With respect to the macroeconomic components and implications of AML Framework in Portugal, there are some problems that should be pointed out. Firstly, the role of Supervision should be reinforced and put really in place. Nowadays, Supervision is the guarantor of market transparency and equality. However, in Portugal, data shows that Supervision has performed its regulatory and guiding role but it has not applied its enforcement power. If Supervision does not punish an activity (no fines for ML or any related practice), the incentives to transgress the underlying rules increase. Moreover, an inoperative Supervision gives a bad signal to the markets and investors, preventing the

attraction of FDI and reducing the interest of economic agents to collaborate with authorities.

In alternative, Supervision should adopt the Risk-based approach. To do it, supervisory bodies must hire different specialists to evaluate and deal with the risky situations. The pattern of investigations should also change, becoming more interventionist and agile, reducing bureaucracy. An investment in know-how might be done in order to create an expertise board dedicated to anticipating the criminal movements and trends, as well as to cooperate with other centers of expertise, both internally and internationally.

Other aspect verified for the Portuguese reality, in a certain way related with the first one, is the small number of reports sent by Financial Institutions to FIU and Attorney General. In some sense, this could be positive since it allows authorities to really investigate the cases that are reported (Crying Wolf problem is not the case here). Nonetheless, an insufficient number of reports reduce the risks of criminals of being caught. This aspects works as an incentive to them, as Economics of Crime showed (see Annex 2). To solve it, public and private bodies should continue the recent efforts to reinforce cooperation, as the increase number of reports denotes.

To enhance the private collaboration and fight non-cooperative behaviors (both the excess and the absence of reports), it can be created a system of fees and penalties, based on the model indicated in the same annex, where governments apply a penalty  $M$  in order to produce an alignment of interests between the hole community and the private behavior. In other words, penalty  $M$  would be the payment correspondent to the negative externality generated by Financial Institutions whenever they would not fulfill the best practices on Compliance. The evaluation of these practices should be carry out by the expertise board created by the Supervisor.

Another crucial aspect is the combat against corruption. This is an urgent combat because the spread of corruption undermines the action of justice and law enforcement, generating a sense of impunity among society, which motivates criminals, make the crime more profitable and induce the introduction of new criminal organizations within the country.

In order to amend this course of action, in my opinion laws should guarantee stronger penalizations for corruption offenses, as well as make a revision of the guaranties of defendants in lawsuits. Regarding these guaranties, all of defendants' rights and the

presumption of innocence should be preserved. Nevertheless, lawsuits should be simplified, reducing bureaucracy and eliminating barriers, merely based in formal issues without content, that sometimes prevent the application of the law.

The last two points are related with the Portuguese judicial system and its procedures. An empirical analysis of the most publicized cases of Portuguese justice such as “Caso BPN” or “Operação Furacão” denotes two major problems: it is very difficult to collect evidences and lawsuits get too much time until the conclusion. These two problems promote the same sense of impunity described above. Again, the economic consequences are the same: an increase of the expected utility of the crime (encouraging economically the crime) and an increment of the illegal activities (which can explain the dimension of Portuguese Shadow Economy when compared with other OECD countries).

To reduce the Shadow Economy the severity of the judicial executions against tax evasion and illegal activities should increase, as Cebula said in his article, and investigations should be more efficient too. These measures would increase the transaction costs within Parallel Economy as well as the risk of being caught. Consequently, the expected utility of the crimes would drop, reducing the frequency of the illegal transactions. In fact, these proposals are in line with the model of Masciandaro where the occurrence of crimes depends on the utility of them.

Finally, in judicial areas directly related with economic aspects, Rule-based approach does not seem to be the best solution, providing an inadequate balance between resources used and results obtained. Alternatively, Risk-based approach should progressively take part in the Portuguese judicial system or, at least, in the decisions related with the distribution of the means to combat financial and economic crime. Notice that this is a request to introduce an economic rationale into the law, rather than a critic against codification based on Civil Code. As Hofstede showed, drawing the cultural traits of Portugal, Portuguese people are extremely risk averse, which probably lead the law to a system where the rights of defendants are more important than the efficiency of the justice. Simultaneously, the sense of impunity can also rely on another Portuguese characteristic which is the degree of acceptance of disparity that Portuguese society has, higher than the majority of other countries present in Hofstede study.

## VI. Limitations and Future Research

### 1. Limitations

During the research process, there were some difficulties that the author would like to highlight now. As it was observable above, Data collected to validate Hypothesis and consequently, to answer Research Questions presents some chronological inconsistencies. It would be desirable that all information gathered were from the same temporal gap, however, this was impossible due to a lack of publicized information and statistics. In Portuguese case, the lack of statistics is even pointed out by FAFT-GAFI in 2006 Report as a weakness of the Portuguese AML system. In the British case, FAFT-GAFI did not publish any update from the initial Third Mutual Evaluation Report, in 2007. In fact, the assessment of British AML Framework after the implementation of third directive from EU is a kind of unknown.

Some of these difficulties regarding data might be overcome through the analysis of other sources. Nevertheless, other information could only be measured through a series of interviews. The main difficulties during interviews were the inability to collect specific data about the direct costs of Compliance Departments and some unawareness about the way Compliance Departments work abroad.

In order to overcome these obstacles, there were created some proxies as it was the case of *number of operations refused*, which was switched by *number of reports*, assuming that the number of reports sent to authorities is a good sample of the total number of operation refused. Also to calculate the opportunity cost of Compliance Departments, it was impossible to collect data about the *average volume of money* associated with transactions refused.

In terms of Reputational Risk, the results from Appendix 6 could not be precise because the cases selected for Portuguese and British reality also included the effects of other risks such as Legal or Liquidity risks. Unfortunately, it was impossible to isolate those risks or try other method to calculate the impact that Reputational Risk has in Equity Value of Financial Institutions.

Finally, studies and rankings about corruption are based not in corruption itself, but rather in the perception of corruption, which is slightly different. Thus, conclusions

using corruption drawn in this Dissertation are supported not by the evidence of corruption, as it should be, but using the image that people has about corruption in their countries.

## 2. Future Research

Regarding future steps, the author would also like to indicate some further steps in order to guide future research based on this Dissertation. First of all, it seems worthwhile to add more countries to this comparison. Due to time constraints the comparison carried out here only compared two countries. To choose these countries it was considered the home country, Portugal, and another European country with a different philosophy regarding laws. Beyond the differences between Civil Law and Common Law observed here, the addition of other countries would reinforce the conclusions of the analysis. Adding countries from other continents and other stages of development would also allow to perform different comparisons about the way private bodies deal with Compliance issues in different geographic zones and draw some conclusions about the impact of development phenomena in these aspects. Moreover, it would be possible to assess a deeper comparison of AML frameworks and consequences of ML through the different economies, particularly between developed and developing ones.

Other future objective should be the enlargement of the variables observed. This means that the inclusion of other economic variables such as *GDP Growth*, *National Competitiveness* or *Financial Markets Efficiency* could be included in a future research. This orientation is supported by literature considering that several authors argue different kind of relations between ML and these indicators (see Annex 10). In the private sphere, the inclusion of data related with *Training Costs* or *Brand Image* would also strengthen the conclusions drawn for the first Research Question.

## VII Annexes

### Annex 1: How to launder money: theoretical steps

According to literature, dirty money goes through three different phases during the laundering process:

- **Placement**

The initial stage occurs when the dirty money – cash generated through illicit acts – is placed into the financial system or in the current markets. For this reason it is called of Placement. This could be done in different ways but payments in cash are the most often. If we are considering the placement in financial institutions instead of acquisitions of goods and services on the market, negotiable instruments such as travellers cheques are used too. To apply the dirty proceeds in the financial sector, banks, building societies or money service business are the preferred targets of criminals (HM Treasury, 2004). At this step, the risk of being detected is high so launderers broken the large amounts of cash available in smaller quantities to deposit them in less conspicuous amounts, sometimes even in different financial institutions. This operation is called smurfing (Vickers, 2005). In the case of not being detected, these smaller quantities of dirty money are generally used to buy financial instruments where some legitimate funds are commingled to divert both the authorities and the departments of compliance. Other common practice is the acquisition of insurance contracts (The World Bank, 2006).

- **Layering**

The second stage is called Layering and it consists on a series of transactions just with the purpose of obscure the real origin of the money or the financial assets acquired in the meanwhile. Assets pass through different institutions assuming different forms during the process such as shares or insurance contracts (HM Treasury, 2004). The usage of Shell Companies abroad and the electronic/wireless international transfers are new fashion ways of accomplish this intermediate phase (US Department of Justice, 2008).

- **Integration**

Lastly, the third phase is called Integration and as the proper name says, it consist in reintegrate the illicit funds in the legal economy giving to them the cleaner face. Usually,

the money is used to buy real estate, luxury goods or even other financial instruments, different from the financial assets used to divert authorities (The World Bank, 2006). In 1996, AUSTRAC released the five broad avenues for disposing of illegal proceeds in Australia. The results had shown that high living standards, storing for future use, valuable assets like real estate, offshore's and replacement in banking system were the top priorities of launderers in Australia (Mackrell, 1996).

Note: In some literature, besides the division of ML flows into three different stages, some authors also point out different typologies of ML flows. In this sense, there are *Domestic flows* when illegal domestic funds are laundered within the home country; *Returning flows* for that funds that return to the home country after being laundered abroad; *Inbound funds* when any host country receive dirty proceeds from crimes committed in other country; *Outbound flows* in the cases where illegal capital flight to another country; and finally, *Flow-Through flows* for that cases where the dirty money passes through the country just as a step of the laundering process (Bartlett, 2002).

## Annex 2: Economic Models

- “The Economics of Crime”

The first person putting this trade-off in economic terms was Becker in 1968, creating what is called by “The Economics of Crime”. He stresses the importance of the cost and benefits as driving forces of criminal behavior. Hence, some people become criminals not because their basic motivation differs, but because their benefits and costs of crime differ (Becker, 1968).

So, any decision has an expected utility ( $EU_j$ ) associated which, in this case, depends on the probability of conviction ( $p_j$ ), the punishment ( $f_j$ ), the utility of the crime ( $U_j$ ) and the income of the crime ( $Y_j$ ).

$$(3) \quad EU_j = p_j \cdot U_j (Y_j - f_j) + (1 - p_j) U_j Y_j$$

Considering that  $p$ ,  $f$  and  $U$  are different from person to person, Becker argues that for the average values of these parameters, we would have the market offense function  $O=O(p,f,U)$  (Becker, 1968).

Although it seems too simplistic, there are empirical evidences which support the older theory. Eide concluded a negative relation between crime prevalence and the severity of punishment (Eide, 2000). Moreover, it is also evident that the perception of a higher likelihood of sanction reduces the chance that individuals will offend (Levitt and Miles, 2007).

Regarding ML, the theory goes further. In fact, ML is not only a crime itself: it is the only way to transform illegal money into legal. This means that, in order to take profit from a criminal act, laundering process is inevitable. Therefore, the decision of criminals is not between laundering or not. It is just about the amount laundered. As a consequence, any AML policy will impact in the amount laundered, rather than in the decision properly. Based on that, the utility of the crime ( $U_j$ ) will depend on the ML process. The risk of being caught, the punishment related with ML offences, the risk of conviction and the transaction costs of ML will affect negatively the amount laundered (Ferwerda, 2008).

- **The Gravity Model**

Gravity Model is more recent and it is based in the physical principles of gravity applied into economy. Walker developed the model in 1995 based on the input-output model where the amount traded between two sides relies on the size of the population in starting point, the attractiveness of the arrival point and the distance between the two points (Walker and Unger, 2009).

Then, the share of proceeds of crime that country  $i$  sends to  $j$  is given by the expression:

$$(4) \quad F_{ij}/M_i = (\text{GNP per capita})_j \times (3BS_j + GA_j + SWIFT_j - 3CF_j - CR_j + 15) / \text{Distance}_{ij}^2$$

Where  $BS_j$  is Banking Secrecy,  $GA_j$  is Government Attitude,  $SWIFT_j$  for SWIFT members,  $CF_j$  is a measure of conflict inside,  $CR_j$  is corruption and finally, distance is measured in Km (Walker, 1995).

- **Microeconomic Model from Masciandaro**

Masciandaro arises with another economic model to explain the criminal behavior and the laundering decisions. He starts assuming that the expected utility of the unlaundered income is zero:

$$(5) \quad U(W) = 0$$

Then, he identifies the important variables of the problem like the amount of illegal income criminals seek to launder ( $Y$ ), the sanction associated with the ML crime ( $T$ ), the probability of being caught ( $p$ ), the cost of ML ( $C$ ) and its monetary benefit ( $B$ ).

Where Benefit is the money laundered plus interests generates by its reinvestment,

$$(6) \quad B = (1+r)Y = mY$$

The cost only depends on the amount laundered,

$$(7) \quad C = cY$$

And the sanction is a multiple of the money laundered (for big amounts the probability of being detected increases) multiplied by a factor of severity of the judicial executions (t):

$$(8) \quad T = tY^2$$

Considering all scenarios with its costs and benefits, the expected utility of criminals (E) could be expressed as a weighted average between the profits when the crime is not detected and the costs associated to its detection in the other scenario through the following expression:

$$(9) \quad E = u[(1-p)(mY-cY) + p(-cY-tY^2)]$$

Where the first term reflects the situation where crime is not detected and the second term the opposite. Notice that this function shows a positive relation between utility and amount laundered, whereas the relation is inverse whether is considered the sanction or the probability of being caught.

After that, Masciandaro calculated the optimal level of money laundered (Y\*) which is given by the following expression:

$$(10) \quad Y^* = [m(1-p) - c] / 2pt$$

So, the optimal amount of money that should be laundered by criminals is never the total amount generated by crime. For huge amounts of money, the probability of being caught increases so much that its negative utility voids the positive utility of money laundered. According to Masciandaro, money laundered is always less than the total of criminal proceeds and it becomes zero only if the profitability of laundered money (which is the interest rate) becomes smaller than the cost of laundered this money, considering the probability of being caught, according to the expression:

$$(11) \quad (1+r) < [c/(1-p)]$$

This means that the determinants of ML phenomena are: the amount generated by crime (positively correlated), the probability of detection (negatively correlated), the severity of sanctions (negatively correlated), the profitability of laundered money

(positively correlated) and the cost of laundering (negatively correlated) (Masciandaro, 2007).

- **The incentive based approach and Pigovian taxes**

In this analysis the author is concerned with any fact that promotes the hidden information between banks and authorities. The excessive number of bank accounts, which limit banks from performing the Basel principles, generates more opportunities for money launderers. The author argues that this is a negative externality for society which nobody pays (neither banks nor criminals) that can be solved with the introduction of a Pigovian tax for non-cooperative banks. The idea is to insert the cost of this externality in the decision of private sector.

In normal terms, banks use stocks of capital ( $K_i$ ) and they are profitable if their benefits, price ( $p$ ) multiplied by the amount of services ( $y$ ), are bigger than costs, both compliance costs ( $c$ ) and interest paid ( $r$ ). The amount of service provided is a function of their stocks of capital and a productivity factor ( $A$ ) typical for capital goods.

$$(12) \quad \Pi_p = py(k_i) - (r+c)(k_i)$$

$$(13) \quad y(k_i) = Ak^\alpha$$

Generally, Banks determine the optimal level of  $k_i$  which maximizes their profit. However, they are never concerned with negative externalities. Therefore, the optimal level of capital goods used is represented by:

$$(14) \quad K^*_i = [(A\alpha p)/(r+c)]^{(1/1-\alpha)}$$

Notice that without compliance ( $c$ ), the amount of capital would be greater, and consequently, the profit would be greater too. There is an economic incentive to reduce compliance.

With the introduction of a Pigovian tax ( $t$ ), the problem of banks is changed,

$$(15) \quad \Pi_p = (p-t)y(k_i) - (r+c)(k_i)$$

And the optimal level of capital used is smaller than before,

$$(16) \quad K^*_i = [(A\alpha(p-t))/(r+c)]^{(1/1-\alpha)}$$

With the right amount of taxes, authorities can be sure that cooperative banks which perform compliance voluntarily have the same optimal level of capital than the non-cooperatives ones paying the Pigovian tax.

Doing the calculations, this level of taxes is represented by the following expression:

$$(17) \quad t^* = (cp)/(c+r)$$

The same author pointed out another solution based on a penalty, rather than a Pigovian tax. In fact, the Pigovian system is almost impossible to perform in practice since authorities are not able to perform a perfect discrimination between cooperative and non-cooperative banks. Furthermore, the right value to  $t$  depends on compliance costs which are an unknown variable to public authorities.

Then, the reality is now expressed by the following formula considering that  $M$  is the pecuniary penalty and  $\pi$  denotes the probability of not being punished:

$$(18) \quad \Pi_i = py(k_i) - rk_i - (1 - \pi)M$$

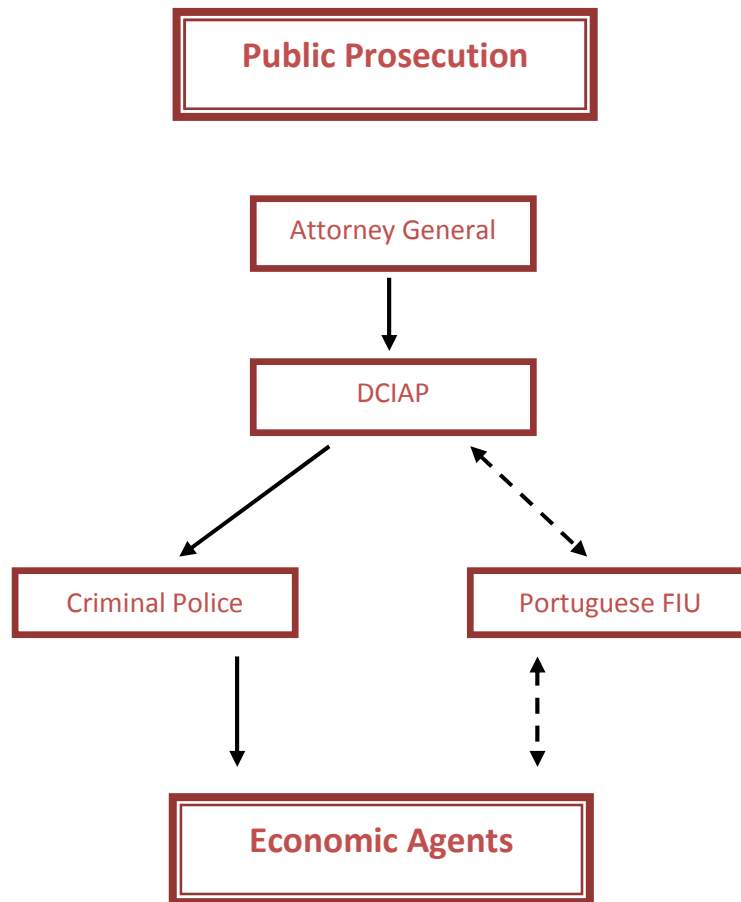
With this new system, authorities only have to define a certain amount  $M$  that promotes  $\Pi_p > \Pi_i$ . In this case, the profit of each bank will be bigger if they perform right compliance. There is an alignment between the social welfare and the private maximization of profit (Araújo and Gadelha).

### Annex 3: Hofstede Results

	Portugal	UK
Individualism	27	89
Masculinity Index	31	66
Uncertainty Avoidance	114	35
Power Distance Index	65	35

Source: Hofstede Website - <http://www.geert-hofstede.com/>

## Annex 4: Brief architecture of Portuguese Law Enforcement and Prosecution system



Attorney General is the maximum responsible for the Central Department for Criminal Investigation and Prosecution, called DCIAP.

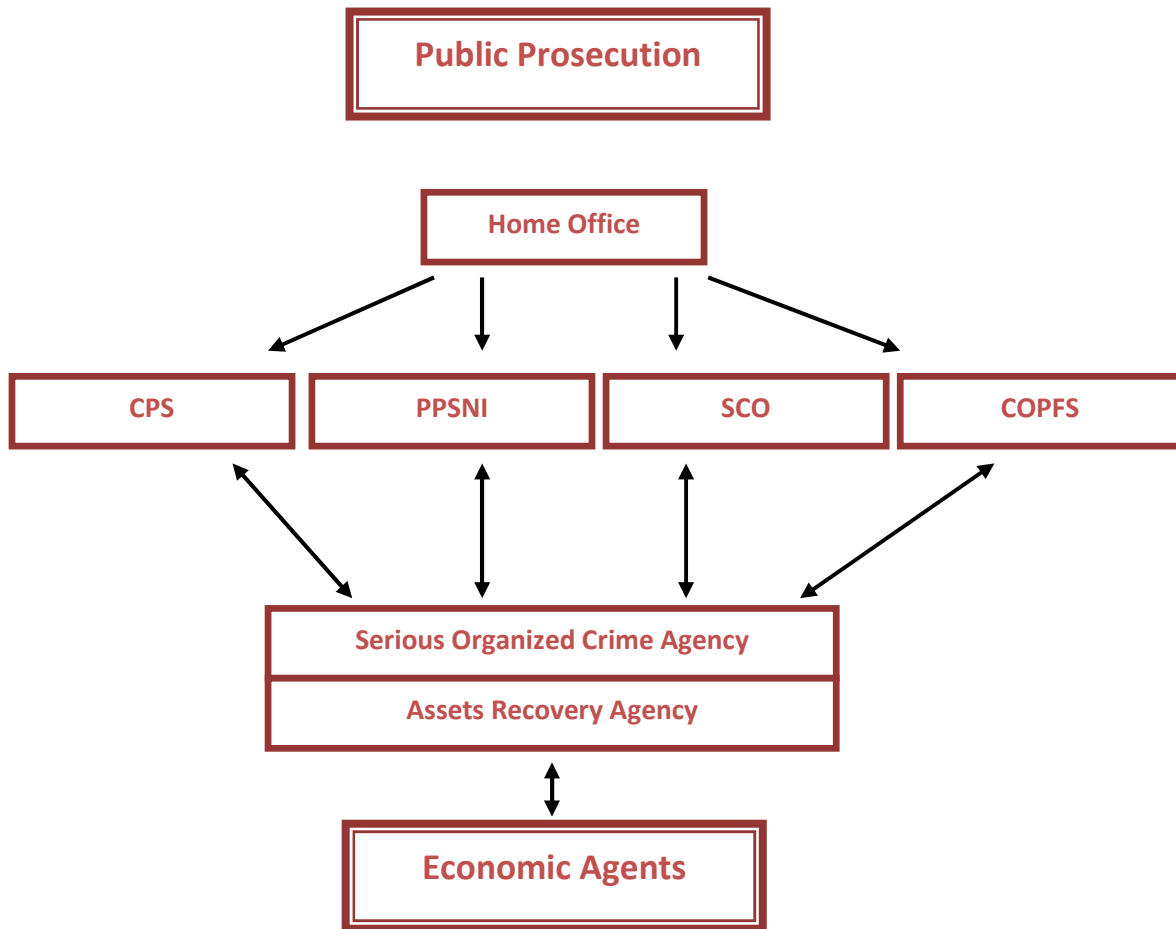
DCIAP coordinates and orients the investigation and prevention against most violent and complex crimes. It has the power to guide the investigation or even stop it.

Criminal Police is responsible to perform the investigation, prosecution and incrimination of individuals, always following the instructions of Public Prosecution, in the field (FAFT, 2006).

Portuguese FIU is a Financial Intelligence Unit able to collect and process useful information in order to articulate polices economic agents and supervisory actors. It also

cooperates internationally with other FIU's (The Egmont Group, 2011). Its scope of action is broader than the investigation itself. It also studies and promotes ways to prevent and combat financial crime. In this sense, FIU does not only investigate but also gives some insights about future improvements of the system and collaborates with private bodies.

## Annex 5: Brief architecture of British Law Enforcement and Prosecution system



Home Office (HM) is responsible for the national security and then, UK has four different Prosecution bodies. Furthermore, it is responsible for the primary legislation concerning ML in UK as well as for the implementation of EU frameworks inside.

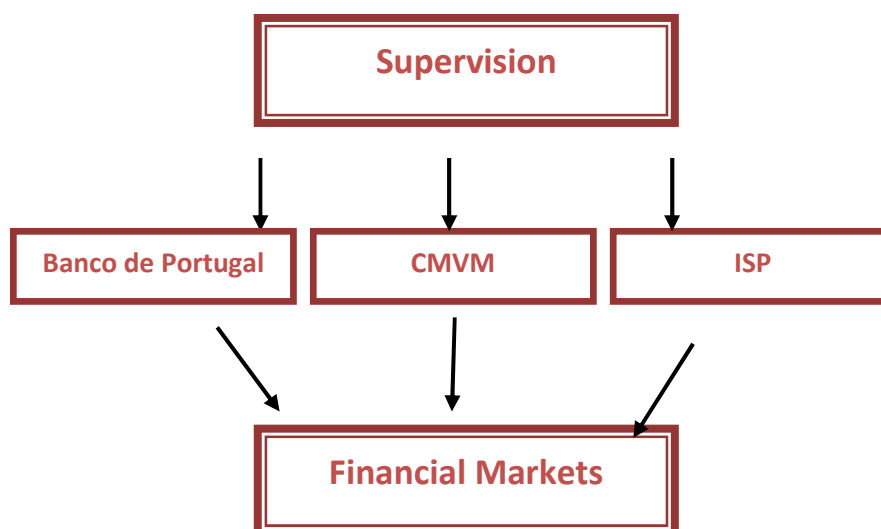
Crown Prosecution Service (CPS) for England and Wales, Public Prosecution Service Northern Ireland (PPSNI) for Northern Ireland, and two in Scotland, the Scottish Crown Office (SCO) and Procurator Fiscal Service (COPFS) are four different Prosecution Authorities working under the tutelage of Attorney General. Prosecution responsibilities encompass collaboration with police, the review and preparation of cases received to the court, and the charge of confiscation orders.

Serious Organized Crime Agency (SOCA) has investigative powers and incorporates British FIU internally. It is the authority which performs the investigation in the field. It is also responsible for the execution of Prosecution instructions, and in financial crimes

Assets Recovery Agency (ARA) is a public body specialized in pursuing asset recovery from criminal activities. It works in collaboration with SOCA whenever the crime demands financial expertise (FAFT, 2007).

## Annex 6: Brief architecture of Portuguese and British Financial Market Supervision

- Portugal

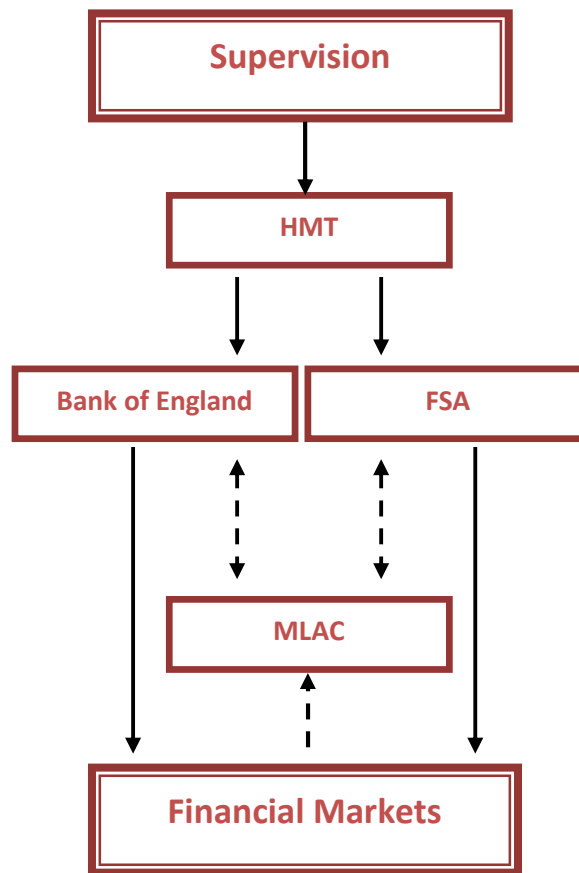


Banco de Portugal (BdP) is responsible for the prudential supervision of credit institutions and investment firms. BdP has power to obtain and copy all information, or even seize them, from credit institutions, to inspect any financial company, to publish regulations and instructions and to call police whenever it is necessary. It can also order the preventive suspension of natural persons who are members of financial institutions in order to safeguard the financial system and its stakeholders (FAFT, 2006).

Comissão do Mercado de Valores Mobiliários (CMVM) has the power to oversee the application of the law and initiate proceeds to prevent ML but it can also perform investigations by itself with the obligation to notify Attorney General of any suspect fact (FAFT, 2006).

Instituto de Seguros de Portugal (ISP) oversees legal duties of insurance companies and it has the power to issue instructions for the industry (ISP, 2011).

- UK



Her Majesty's Treasury (HMT) is responsible for all policy on the regulation of the UK's financial sector (HMT, 2011). HMT is in charge of implementing EU Money Laundering Directives and international sanctions, approve the financial industry guidance and go along internal sanctions and asset freezes. To carry out monitoring and supervising activities, HMT coordinates the Bank of England (BoE) and the Financial Service Authority (FSA) (FAFT, 2007).

Bank of England (BoE) is the central bank of UK with responsibilities on the promotion of stability of financial system. Among these responsibilities, BoE acts as an agent of HMT in the administration of financial sanctions as well as in the maintenance of an up to date list of financial sanctions targets.

Financial Service Authority (FSA) is the main AML regulator in UK. Inside its regulation activities FSA has a range of rule-making, investigatory and enforcement powers (FAFT, 2007). It also issues orientations and critical perspectives of AML Frameworks in its FSA Handbooks (FSA, 2005a).

The Money Laundering Advisory Committee (MLAC) is another public department which does the linkage between public regulators and private associations. It is a forum for public and private stakeholders to discuss the AML Framework and review its shape and efficiency (FSA, 2011).

## **Annex 7: British private bodies working on AML Framework**

- **The Joint Money Laundering Steering Group (JMLSG)**

The Joint Money Laundering Steering Group (JMLSG) is a corporation on which financial service providers are represented (FAFT, 2007). JMLSG are very important in UK because it sets up the industry guidance which establishes the compromise of private institutions in their self-regulation (JMLSG, 2011).

- **British Bankers association (BBA)**

British Bankers Association (BBA) convenes almost all banks operating in UK, representing them and issuing some statistics and publications about the industry (BBA, 2011).

- **Association of British Insurers (ABI)**

Association of British Insurers (ABI) is pretty similar with BBA but for insurance industry (ABI, 2011).

## **Annex 8: Status of Implementation of FAFT-GAFI Recommendations in Portugal and UK**

- **Portugal**

Portugal was found to be compliant or largely compliant with the majority of FAFT recommendations in 2006. In the following years, Portugal did a recognized effort to improve in recommendations where it was ranked poorly (eStandards Forum, 2011). New laws approved in 2007, in conjunction with the revision of Penal Code in 2008, have extended Portugal's AML Framework to cover financial terrorism and gave competencies to judge legal persons according to the Penal Code (Law nº59/2007)<sup>8</sup>. Nonetheless, Portugal still lags in adhering to the standards on the identification of beneficial owners, as well as producing adequate statistics about AML Framework (eStandards Forum, 2011).

Moreover, an US report from 2009 stresses the problem that the number of ML convictions is too low in Portugal. The report continues arguing that no significant criminal assets have been identified or seized. Consequently, Portugal must improve its efforts at freezing and seizing funds (U.S. Department of State, 2009).

In the table below it is a resume of FAFT-GAFI Recommendation in which Portugal is not fully compliant.

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<sup>8</sup> See PDF Version of Law nº59/2007 in: <http://dre.pt/pdf1sdip/2007/09/17000/0618106258.pdf> [accessed 16 May 2011]

# Recommendation	Reason indicated
12	2010 report is silent in some of the flaws previously detected for customer due diligence and record keeping obligations of designated non-financial businesses and professions (DNFBPs).
16	Portugal started requiring DNFBPs to get training and improved the warnings related to non-cooperative jurisdictions. However, the report does not offer a new level of compliance with this recommendation.
24	Entities with duties to monitor DNFBPs carry out very few inspections, possibly because there are insufficient resources to do it.
33	The level of information available about beneficiary persons and the transparency of the shareholders of companies that have issued bearer shares seem to be limited. There are also doubts about the capacity of authorities to efficiently get information about beneficial owners of business placed in Madeira Free Trade Zone.

*Source:FAFT-GAFI Portugal MER –DOC. FAFT/ME (2006)7, Second Update; eStandards Forum Website*

*<http://www.estandardsforum.org/portugal/standards/anti-money-laundering-combating-terrorist-financing-standard>*

- **UK**

Regarding UK, the implementation of ML policy that came into force in December 2007 is in line with EU's Third Money Laundering Directive and addresses solutions to some mature problems like beneficial ownership requirements or customer due diligence. Nevertheless, it is noted that UK remains attractive for money launderers due to the large size and sophistication of its financial markets (U.S. Department of State, 2009).

According to the original Third Mutual Evaluation Report from 2007 (there is no update available until now), and excluding the identified problems which should be solved by the application of the EU's Third Money Laundering Directive, British Framework presents problems in addressing some recommendations.

In the table below it is a resume of FAFT-GAFI Recommendation in which UK is not fully compliant.

# Recommendation	Reason indicated
9	It was identified a lack of compliance based on the incapacity of authorities to process the origin of third parties and their relations with non-cooperative jurisdictions where they can be settled.
15	It was pointed out the need of requirements to screening employees or to maintain an independent audit function.
22	The same lack of requirements observed in Recommendation 15 applies to Foreign Branches, colliding with Recommendation 22.
36	FAFT-GAFI has still some doubts about the ability of British authorities to handle mutual legal assistance in a timely effective manner.

*Source: FAFT-GAFI The United Kingdom and Northern Ireland – Third Mutual Evaluation, 29 June 2007; eStandards Forum Website <http://www.estandardsforum.org/portugal/standards/anti-money-laundering-combating-terrorist-financing-standard>*

## Annex 9: International Institutions with AML Action

- **UN**

UN was the first organization to look into the ML problems using its international nature as an advantage to deal with these supranational challenges (UN, 2011)<sup>9</sup>. Its international power is demonstrated by the capacity to translate to the national laws the resolutions of its treaties and conventions (The World Bank, 2006). These days, UN manages the Global Programme Against Money Laundering (GPML). GPML set up some objectives based on the providence of assistance to reinforce the knowledge of people fighting ML as well as to develop the legal framework in some exposed countries (GPML, 2011). UN also had a crucial contribution to the definition of ML worldwide through its two conventions: Vienna Convention which was pioneer addressing these issues (Vienna Convention, 1988)<sup>10</sup>, and Palermo Convention (Palermo Convention, 2000)<sup>11</sup>.

Vienna Convention established for the very first time the concept of ML (although it did not use the term yet) calling upon countries to criminalize it. However, Vienna remained limited in respect to the unique underlying crime considered: drug trafficking. Additionally, Vienna did not address any preventive measure against ML (The World Bank, 2006).

Palermo Convention gave a broad expression to ML enlarging its underlying crimes. Moreover it stresses the importance of deterrence activities and international cooperation (Palermo Convention, 2000). Palermo was extremely efficient against organized crime in some countries like Colombia or Jordan mainly due to the increase of consistency in juridical system. Palermo Convention implemented uniform and transparent rules, improved coordination between judicial institutions and police, reviewed the consistency of courts decisions and engaged civil society to the fight against ML (Buscaglia, 2008).

- **The Financial Action Task Force**

FAFT was formed in 1989 by G7 countries with the purpose of developing and promoting the international response against ML. Its goals are promoting the adoption of FAFT

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<sup>9</sup> See the list of members of UN in: <http://www.un.org/en/members/index.shtml> [accessed 16 May 2011]

<sup>10</sup> See the PDF version of the document in: [http://www.unodc.org/pdf/convention\\_1988\\_en.pdf](http://www.unodc.org/pdf/convention_1988_en.pdf) [accessed 16 May 2011]

<sup>11</sup> See the PDF Version of the document in: [http://www.uncjin.org/Documents/Conventions/dcatoc/final\\_documents\\_2/convention\\_eng.pdf](http://www.uncjin.org/Documents/Conventions/dcatoc/final_documents_2/convention_eng.pdf) [accessed 16 May 2011]

Recommendations against ML and FT, monitoring its members and their capacities to fulfill recommendations and finally reviewing and publicizing new trends in ML schemes (FAFT, 2011).

During the monitoring process, members respond to standard questionnaires on an annual basis assessing the degree of implementation of The Forty Recommendations plus Nine Special Recommendations from FAFT. After that, FAFT performs a mutual evaluation per each country relating its conclusions in a report. Mutual evaluations are uniform to all countries in accordance to criteria defined by FAFT, IMF and World Bank. Countries which do not take the necessary steps suffer, in a primary phase, peer pressure from the others and in a second phase, they can be even excluded from FAFT. Non-cooperative countries are publicized in NCCT List where there are all jurisdictions that serve as obstacles to international cooperation. The commercial relations with these countries are hampered and sanctions can occur (The World Bank, 2006).

FAFT also has regional bodies which allow a closer monitoring of each region. In Europe, FAFT organism is the Council of Europe – MoneyVal (Council of Europe, 2011).

- **The Basel Committee**

The Basel Committee was formed in 1974 by ten Central Banks or other supervisors and despite not having any legal power it draws best-practices and guidelines to the bank industry. It supplies expertise in several areas such as accountability, compliance or risk management (BIS, 2011).

The first document issued by the Basel Committee related with ML, The Prevention of Criminal Use of the Banking System for the Purpose of Money-laundering focused on the integrity of the banks and the necessity to prevent the usage of banks channels for illegal acts. To do it, this document emphasizes customer identification, compliance and an ethical culture of cooperation between banks and authorities. Training and quality of auditing were other points stressed in this document (Basel Committee, 1988)<sup>12</sup>.

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<sup>12</sup> See the PDF version of the document in: <http://www.bis.org/publ/bcbssc137.pdf> [accessed in 16 May 2011]

Then, The Core Principles for Effective Banking Supervision (Basel Committee, 1997)<sup>13</sup> and The 1999 Core principles Methodology correct and add some more features to KYC procedures (Basel Committee, 1999)<sup>14</sup>.

- **The Egmont Group**

The Egmont Group aggregates the Financial Intelligent Unit's (FIU) of different countries. Egmont Group is served by five working group, each one dedicated to different areas of expertise: Legal Working Group, Outreach Working Group, Training Working Group, Operation Working Group and IT Working Group (Egmont Group, 2009)<sup>15</sup>. These units are the national agents of AML international frameworks. Each FIU works as a bridge providing the exchange of information between financial institutions and law enforcement authorities of its country. However, this is the type of work where international cooperation really adds value. To ensure better expertise and communication capabilities, several FIU's started working together forming a forum where information and experiences are shared (The World Bank, 2006).

- **International Association of Insurance Supervisors**

The International Association of Insurance Supervisors founded in 1994 meets more than 100 countries and jurisdictions (IAIS Members, 2011), and it has as primary goals the promotion of cooperation between insurance regulators in a coordinate environment with other financial institutions, the provision of training and the application of international standards among the agents within insurance sector. These objectives are guided to address some hot issues such as internet transactions or Codes of Conduct (IAIS, 2011).

- **International Organization of Securities Commissioners**

The International Organization of Securities Commissioners is a democratic organization composed by regulatory bodies, exchanges markets which are self-regulated and associate members (IOSCO, 2011). The core objectives of organization are the protection of investors, the regulation of the market (ensuring their fairness and efficiency) and the reduction of systematic risk (IOSCO, 2003).

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<sup>13</sup> See the PDF version of the document in: <http://www.bis.org/publ/bcbsc102.pdf> [accessed in 16 May 2011]

<sup>14</sup> See the PDF version of the document in: <http://www.bis.org/publ/bcbs61.pdf> [accessed 16 May 2011]

<sup>15</sup> See The Egmont Structure in: <http://www.egmontgroup.org/about/structure-and-organization-of-the-egmont-group> [accessed 16 May 2011]

- **Wolfsberg Group of Banks**

The Wolfsberg Group is an association of 12 international private banks which set up a bunch of AML principles to private banking sector. It is totally different of previous institutions since it was created by the private sector as a self-regulation effort (The Wolfsberg Group, 2011). The Wolfsberg Standards are an independent attempt to draw an AML/FT orientation regarding to monitoring and reporting operations, correspondent banking or risk-based approach directives among others (The Wolfsberg Group, 2011).

- **Commonwealth Secretariat**

The Commonwealth Secretariat is a voluntary association of states (all former British Rule countries with the exception of Mozambique) which cooperates in an ample range of issues including peace and fighting terrorism (The World Bank, 2006). In this sense, Commonwealth Secretariat assists members in the implementation of AML measures (Commonwealth Secretariat, 2007).

## **Annex 10: Other sensible variables referred on academic literature**

- **Existence of Organized crime**

There are several factors that can explain the existence of mafias and criminal organizations. The geographic distance and inaccessibility from the centers of power reduce the authority of governments and its judicial enforcement. Social distance also matters since there are some discriminated communities which are not fully integrated in our societies and they do not recognize police or judicial system. For these communities, the social order is indifferent for their welfare. Finally, banning the production or distribution of any good or service generally creates parallel markets appropriated by crime organizations (Kumar and Skaperdas, 2008).

This issue is particularly related with ML and FT because there is strong evidence supporting that ML is performed by groups belonging to Organized Crime (Schneider, 2008). The existence of mafias promotes the creation of monopolistic markets where organized crime receives all surpluses from these markets. This privilege position allows them to abuse the citizens through the imposition of high prices or even discrimination policies (Grossman, 1995).

Furthermore, the existence of mafias promotes a non-economic completion based on violence and fear. Sometimes, different criminal groups fight against each other to keep their regional monopolies. In this case, the competition is more a sort of monopolistic competition, rather than a pure monopoly. The combat between mafias is very costly and inefficient, and generally, it is paid by society and its resources. Doing business with crime organizations also has more costs of transaction (uncertainty and violence). Regarding production, mafias never employ their resources on production system and technological progress. The human capital is trained to predate and thief, rather than to produce (Kumar and Skaperdas, 2008).

- **Growth and GDP**

The relation between ML and economic growth is very difficult to estimate, mainly due to the fact that there are very different aspects with impact in GDP and it is very difficult to separate these effects. Labor productivity, foreign investment, social insurance system or natural resources are some examples of those factors. Nevertheless, there is a statistical study based on a linear regression model indicating that 23,7% of the variation

in real GDP is explained by the variation of laundered money within economy. The correlation is positive and valid for short term growth (Stancu and Rece, 2009).

Although this result seems strange, it is quite obvious, excluding the long term effects, indeed. Money laundered is money which returns to economy, providing funds both for consumption and investment heating the economy immediately (Araújo and Moreira, 2005). According to this, countries with no AML Framework in place can be behaving as free-riders, benefiting from capital transfers between cooperative countries and these second ones. At the same time, money laundering can be seen as a redrawn from the criminal activity because when criminals invest in criminal activities they do not launder the money first. In this sense, more money laundered means more money in the real economy (Cavalcante and Andrade, 2006).

In the long-term, ML is very harmful to economic development and GDP. Criminals use shell companies which had had a previous licit activity to perform ML and FT hiding the illicit funds. This creates artificial distortions of the market. Sometimes, those shell companies are able to offer products at prices below the manufacturer costs – predatory pricing – destroying competition (McDowell and Novis, 2001). Additionally, these front companies can create a misallocation of resources within economy since the prices are also distorted itself, and consequently, the economic incentives are changed. Shell companies are also a vehicle to fiscal evasion (The World Bank, 2006).

From the political point of view, ML phenomena are also dangerous. The distortions observed before are also extended to the currency demand since ML/FT operation are transnational and occur in different currencies during the process. Thus, fluctuations caused by ML flows spread an instable environment among exchange and interest rates. This instability harms growth. Other source of concern is related with privatizations since, in countries with high criminal incidence, criminals could be the buyers of them, damaging the future perspectives of growth in those countries. (McDowell and Novis, 2001).

- **Financial Markets and Institutions**

Finally, it will be useful to observe the impacts of ML and FT in financial markets and institutions itself. Beyond the legal exposition, the existence of ML operations within bank accounts is a source of reputational and concentration/liquidity risk. Concentration risk comes from the potential loss generated by shell companies and other intangible clients which cannot have enough assets to serve as collateral in case of default. Liquidity

risk also increases because these clients are generally very active and unpredictable using their accounts. Banks with a great exposition to these clients have risky balances due to the exposure to massive withdrawals (The World Bank, 2006). Reputational risks occur when society and clients realize that the bank deals with money launderers. This can certainly be a huge loss to financial brand, with impacts in the level of customer confidence, in a sector where trust is the most important asset (Bartlett, 2002).

Another aspect is the internal erosion banks suffer when they deal with criminals. In this sense, erosion means the possibility of the institution becomes corrupt itself or criminal oriented. Usually this happens because criminals are in touch with the employees of the bank, corrupting them (Bartlett, 2002). Even among honest people, sometimes persons become self-interested and take arguably unethical decisions based on these interests (Chua and Zou, 2009).

Concerning financial markets, the increase of security measures causes an increase of transaction costs for ML operations (Johnston and Nedelescu, 2005).

## **Annex 11: Timeline for Northern Rock bank Crisis**

### **14 August 2007**

Bank of England governor Mervyn King is alerted to the potential impact of the global credit squeeze on Northern Rock's business in a phone call with officials at the Financial Services Authority (FSA) and the Treasury.

### **4 September 2007**

The three-month loan rate hits 6.7975%, above the Bank of England's emergency lending rate of 6.75%, suggesting that banks are reluctant to lend money to each other.

### **14 September 2007**

Northern Rock says "extreme conditions" in financial markets forced it to approach the Bank of England for assistance.

### **9 October 2007**

The Treasury agrees to protect new savings deposited at Northern Rock. The decision extends the previous guarantee, made the previous month, which covered deposits made up to 19 September.

### **15 January 2008**

British media learn that the government has got a plan in place should the Northern Rock be taken into public ownership. Legislation will be used, rather than the Treasury simply acquiring the firm in the conventional way, or allowing it to go into administration and then buying the assets.

### **4 February 2008**

The deadline for offers for Northern Rock. Sir Richard Branson's Virgin Group and Northern Rock's own board both make rescue proposals for the bank.

### **17 February 2008**

Neither of the two proposals tabled for Northern Rock - one from a group led by Virgin and the other from in-house management - offer enough value to the taxpayer, Chancellor announces. Therefore, he says, the bank will be nationalized.

### **18 February 2008**

Shares in Northern Rock are suspended.

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Source: BBC News (2008), 5 August 2008 - <http://news.bbc.co.uk/2/hi/business/7007076.stm>

## **Annex 12: Timeline for BCP Leadership Crisis**

### **8 May 2007**

Jardim Gonçalves presents some statutory changes.

### **28 May 2007**

The proposal is removed without being voted.

### **2 June 2007**

First rumors about the destitution of Paulo Teixeira Pinto and the guerrilla environment between several directors.

### **24 July 2007**

A proposal from Paulo Teixeira Pinto to enlarge the number of members in the Board of Directors is rejected by Chairman of the House.

### **2 August 2007**

Chairman of the House accepts a new proposal to enlarge the number of members in Board of Directors.

### **6 August 2007**

A computer problem prevents the suffrage of proposals.

### **27 August 2007**

Computer problem is solved and starts the continuation of the proposals' discussion. However, the proponents retire their proposals.

### **31 August 2007**

Paulo Teixeira Pinto announces his resignation.

### **12 October 2007**

Portuguesa media announce irregularities in financial operations carry on by the son of Jardim Gonçalves involving BCP.

### **15 October 2007**

CMVM ask for some clarifications regarding the case of Jardim Gonçalves' son.

### **4 December 2007**

Jardim Gonçalves announces his resignation.

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Source: RTP (2007), 4 December 2007 - <http://ww1.rtp.pt/noticias/?article=89863&visual=3&layout=10>

## VIII Appendixes

### Appendix 1: Hypothesis and Data Collected

Hypothesis	Data Collected	Type of Sources
H <sub>1</sub>	Estimative of Direct costs of Compliance	Bank Interviews in Banif, Barclays, Santander Totta and Caixa Geral de Depósitos
	Number of operations refused	SOCA Annual Report; Unidade de Investigação Financeira Annual Report; FAFT-GAFI Mutual Evaluation Reports
	(Net Interest Income + Net Commissions Income + Other Incomes)/Total Assets	Annual Reports from Banks; Journals
H <sub>2</sub>	Number of Fines paid	FAFT-GAFI Mutual Evaluation Reports
	Losses observed in exchange markets caused by Reputational Crisis	Historical data gathered in Financial Websites and Journals
H <sub>3</sub>	Assets Freeze	SOCA Annual Report; FAFT-GAFI Mutual Evaluation Reports
	Number of Enquiries	FAFT-GAFI Mutual Evaluation Reports
	Number of Convictions	FAFT-GAFI Mutual Evaluation Reports
	Results from Corruption Perception Index	Corruption Perception Index, 2011
H <sub>4</sub>	Fines Levied by Supervisory Authorities	FAFT-GAFI Mutual Evaluation Reports
	FDI in Portugal and UK	UNCTAD Website
H <sub>5</sub>	Number of Reports from Banks	SOCA Annual Report; FAFT-GAFI Mutual Evaluation Reports
	Size of Informal Economy in % of GNP	Academic Paper

## Appendix 2: Estimative of Direct costs of Compliance (data collected from interviews)

	Human Resources	Investments in IT	Expenditures on Training
Portugal	10* <sup>1</sup>	Unquantifiable. Initial costs presumably similar,	
UK	70* <sup>2</sup>	Variable costs dependent on number of transactions.	Unquantifiable.

\*<sup>1</sup>Average value calculated through the answers gathered during the interviews

\*<sup>2</sup> Indicative value collected during the interviews based on the perceptions of Portuguese analysts about British system, considering the examples of Barclays and Abbey in UK

*Source: Interviews with Compliance Departments of CGD, Barclays, Banif and Santander Totta*

## Appendix 3: (proxy) Number of operations refused

	2008	2009	2010
Portugal	671	753	1061
UK	No data	6.786*	7.142

\* The exact value is not available. This value comes from the assumption that the proportion of reports from banks in the total universe during 2009 is the same of 2010.

*Source: SOCA Annual Report 2009/2010; FAFT-GAFI Portugal MER –DOC. FAFT/ME (2006)7, Second Update; Unidade de Investigação Financeira Annual Report 2010*

#### Appendix 4: (Net Interest Income + Net Commissions Income + Other Incomes)/Total Assets (Values for 2010)

	Banks	Net Interest Income + Net Commissions Income	Total Assets	Bank's margins	Country's average Bank's margins
Portugal	BCP	2.892M€	100.010M€	2,89%	<b>2,43%</b>
	BPI	1.099M€	45.660M€	2,4%	
	BES	1.505M €	75.963M€	2%	
UK	Barclays	32.204M£	1.489.645M£	2,2%	<b>2,3%</b>
	RBS	32.662M£	1.453.576M£	2,3%	
	Lloyds	23.986M£	991.574M£	2,4%	

Source: BES Relatório e Contas 2010/2011; BCP Relatório e Contas 2010/2011; BPI Relatório e Contas 2010/2011; Barclays PLC Annual Report 2010, 2011; 2010 Results News Release, Lloyds Banking Group, 2011; RBS Annual Report and Accounts 2010/2011; Jornal Sol, 31 January 2011- [http://sol.sapo.pt/inicio/Economia/Interior.aspx?content\\_id=10455](http://sol.sapo.pt/inicio/Economia/Interior.aspx?content_id=10455)

#### Appendix 5: Number of Fines paid

	2005
Portugal	0*
UK	53

\*According to the FAFT-GAFI comments with respect to Recommendation 17 stated in FAFT-GAFI Portugal – Third Mutual Evaluation, 13 October 2006

Source: FAFT-GAFI Portugal – Third Mutual Evaluation, 13 October 2006; FAFT-GAFI The United Kingdom and Northern Ireland – Third Mutual Evaluation, 29 June 2007

## Appendix 6: Losses observed in exchange markets caused by Reputational Crisis

	Reputational Scandals	Considered period	Initial Price	Final Price	Devaluation in the Stock Market	Average Devaluation caused by Reputational Crisis per country
Portugal	BCP Leadership Crisis	1 <sup>st</sup> June 2007 until 31 <sup>st</sup> December 2007* <sup>1</sup>	3,4105	2,6636	<b>-21,9%</b>	<b>11,05%</b>
	“Operação Furacão” in BES	17 <sup>th</sup> October 2005 until 17 <sup>th</sup> November 2005	6,212	6,2026	<b>-0,2%</b>	
UK	Northern Rock Bank Crisis	13 <sup>th</sup> August 2007 until 18 <sup>th</sup> February 2008* <sup>2</sup>	14,35	1,95	<b>-86,4%</b>	<b>89,95%</b>
	RBS’ liquidity problems and Bankruptcy Rumors	29 <sup>th</sup> September 2008 until 19 <sup>th</sup> January 2009	186,20	12,10	<b>-93,5%</b>	

\*<sup>1</sup>See Annex 12

\*<sup>2</sup>See Annex 11

Source: Yahoo.Finance, 2011; Diário Económico, 31 July 2007 - [http://diarioeconomico.sapo.pt/edicion/diarioeconomico/edicion\\_impresa/politica/pt/desarrollo/1022196.html](http://diarioeconomico.sapo.pt/edicion/diarioeconomico/edicion_impresa/politica/pt/desarrollo/1022196.html); Financial Content, 2011 - <http://markets.financialcontent.com/stocks/quote/historical?Month=2&Symbol=365%3A720373&Year=2008&Range=12>; CEOMagazine, 19 January 2009 -

<http://ceoworld.biz/ceo/2009/01/19/how-royal-bank-of-scotland-lost-37-billion-technically-insolvent>

### Appendix 7: Assets Freeze

	2008	2009	2010
Portugal	10.489.000€	14.700.000€	25.601.884€
UK	No data	32.175.000€	36.021.314€

*Source: SOCA Annual Report 2008/2009; SOCA Annual Report 2009/2010; FAFT-GAFI Portugal MER –DOC. FAFT/ME (2006)7, Second Update; Unidade de Investigação Financeira Annual Report 2010*

### Appendix 8: Fines Levied by Supervisory Authorities

	2005
Portugal	0*
UK	53

\*According to the FAFT-GAFI comments with respect to Recommendation 17 stated in FAFT-GAFI Portugal – Third Mutual Evaluation, 13 October 2006

*Source: FAFT-GAFI Portugal – Third Mutual Evaluation, 13 October 2006; FAFT-GAFI The United Kingdom and Northern Ireland – Third Mutual Evaluation, 29 June 2007*

### Appendix 9: Number of Reports from Banks

	2008	2009	2010
Portugal	671	753	1.061
UK	No data	6.786*	7.142

\* The exact value is not available. This value comes from the assumption that the proportion of reports from banks in the total universe during 2009 is the same of 2010.

Source: SOCA Annual Report 2009/2010; FAFT-GAFI Portugal MER –DOC. FAFT/ME (2006)7, Second Update; Unidade de Investigação Financeira Annual Report 2010

### Appendix 10: Number of Enquiries

	2003	2004	2005	2008	2009	2010
Portugal	61	134	13	200	154	128*
UK	211	552	1.327	No data	No data	No data

\* The value for the whole year is based on estimations calculated through the values available until the 1<sup>st</sup> half of the year

Source: FAFT-GAFI The United Kingdom and Northern Ireland – Third Mutual Evaluation, 29 June 2007; FAFT-GAFI Portugal – Third Mutual Evaluation, 13 October 2006; FAFT-GAFI Portugal MER –DOC. FAFT/ME (2006)7, Second Update

### Appendix 11: Number of Convictions

	2003	2004	2005	2008	2009
Portugal	6	4	2	16	14
UK	108	207	595	No data	No data

Source: FAFT-GAFI The United Kingdom and Northern Ireland – Third Mutual Evaluation, 29 June 2007; FAFT-GAFI Portugal – Third Mutual Evaluation, 13 October 2006; FAFT-GAFI Portugal MER –DOC. FAFT/ME (2006)7, Second Update

### Appendix 12: Percentage of Convictions based on the volume of Enquiries

	2003	2004	2005
Portugal	9,8%	3%	15,3%
UK	51,2%	37,5%	44,8%

### Appendix 13: FDI in Portugal and UK

	2000		2001		2002		2003	
	Equity	Total	Equity	Total	Equity	Total	Equity	Total
Portugal	4.237M€	5.161M€	1.068M€	4.396M€	1.445M€	1.351M€	1.428M€	732M€
UK	68.181M€	91.839M€	23.436M€	42.769M€	13.292M€	18.759M€	3.861M€	14.545M€

Source: FDI in Brief: United Kingdom, UNCTAD, March 2004; FDI in Brief: Portugal, UNCTAD, September 2005

### Appendix 14: Size of Informal Economy in % of GNP

	1999/2000	2001/2002
Portugal	22,7%	22,5%
UK	12,7%	12,5%
Average over 21 OECD countries	16,8%	16,7%

Source: Schneider F. (2002), Size and Measurement of the Informal Economy in 110 Countries around the World, University of Linz

### Appendix 15: Results from Corruption Perception Index

	2005	2006	2007	2008	2009	2010
Portugal	6,5	6,6	6,5	6,1	5,8	6
UK	8,6	8,6	8,4	7,7	7,7	7,6

Source: Corruption Perception Index, 2011

Notes: The values in Pounds and Dollars were translated to Euros at the exchange rate of 31<sup>st</sup> December 2010 (£1 = 1,17€) and (\$1 = 0,755€). In some statistics in UK, from SOCA for instance, it is considered periods of a year starting at October and ending in the following September. To simplify the analysis, the year considered in these tables is always started on 1<sup>st</sup> January.



Católica-Lisbon - School of Business and Economics

# Interview Guide

Master Dissertation in Financial Crime and Compliance

Pedro Miguel Carvalho

Spring, 2011

Preliminary notes: The information gathered in these interviews will be strictly used for the unique purpose of this Master Dissertation. The interviewer will validate with respondents, at the end of interviews, the information collected. All information is confidential and will be presented on the Master Dissertation in an anonymous way. Names or Brands referred on the interview only be presented in Master Dissertation when necessary and with no relation with the data collected in the questionnaire. The interviewer will follow the principles of ethics and confidence.

## Section I – Compliance organization

How is the Compliance Department structured?

Does Compliance focus on all clients and bank accounts? In case of not, how is the screening methodology?

## Section II – Compliance Costs

On average, how many operations does Compliance refuse per year? What is the average amount of them?

Currently, what is the bank's margin average?

What is the cost, per year, of Compliance Department?

### Section III – Compliance Profits

Why does the bank have Compliance Department? Is it for legal or business reasons? What type of business reasons?

How do you measure the efficiency of Compliance? Can you estimate the amount saved in fines? Can you estimate the profit generated by the reduction of reputational risk?

## Section IV – Additional comments

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