

Andjela Jurisic

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United Kingdom's AML/CFT Listing Methodology for
High-Risk Third Countries*

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Neapolis University Pafos, School of Law

Pafos, 8042, Cyprus

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Strengthening Financial Safeguards: An Analysis of the United Kingdom's AML/CFT Listing Methodology for High-Risk Third Countries

Abstract

The United Kingdom (UK) has a long history of developing counter-money laundering policies for countries identified as terrorist-supporting states. However, since the 9/11 attacks, the UK has significantly increased its efforts to combat the financing of terrorism, making it a significant policy area. In recent years, several critical political changes have affected the UK's ability to combat terrorism and money laundering efforts. The 2016 decision of the United Kingdom to leave the European Union (EU) has raised several concerns regarding the country's ability to protect itself from the threat of terrorism effectively. This event has led to a significant overhaul of the UK's security framework, with the exit from the EU generating a substantial capacity for the UK to develop its policy outside the EU's Supervisory framework. Two of the critical measures under review are the UK's list of Anti-Money Laundering (AML) and Counter-Terrorism Financing (CTF) regimes. These lists are used to identify and monitor countries with a heightened potential for terrorist financing activity and to ensure appropriate measures are in place to mitigate the associated risks. This paper briefly evaluates the EU Revised Listing Methodology 2020 to provide an initial and short analysis of whether and how to revise such methods in the post-Brexit era.

Key words:

Brexit, European Union, United Kingdom, high-risk third countries, anti-money laundering, listing methodology.

1. Introduction

The 2016 decision of the United Kingdom (UK) to leave the European Union (EU) has created uncertainty in various sectors, including finance, real estate, and law, where Anti-Money Laundering (AML) and Counter-Terrorist Financing (CTF) regulations are crucial. AML involves combating the conversion, transfer, or concealment of criminal funds, while CTF targets funds collected for terrorist acts. The UK's departure from the EU means it no longer follows EU regulations in the AML/CTF area.

The UK previously relied on the Financial Action Task Force's (FATF) list of high-risk third countries to combat money laundering and terrorist financing. However, the FATF's existing risk-based approach was criticized for not addressing de-risking and lacking robust risk measurements. Post-Brexit, the UK has an opportunity to develop its unique AML/CTF listing methodology, leveraging regulatory independence.

The UK's AML/CTF program is risk-based and targets high-risk activities and individuals to prevent criminal abuse of the financial system. It includes enhanced due diligence, customer due diligence, and suspicious activity reporting. The paper aims to investigate whether the post-Brexit UK should create its own list of high-risk AML/CTF countries or continue relying on the FATF standard. Three testable statements will guide the analysis:

H1: Collective action and unified lists are inferior to country-specific listing methodologies for AML/CTF issues.

H2: The EU Revised Listing Methodology contains distinct and beneficial features that differ from the FATF standard but may not fit the UK entirely.

H3: In a post-Brexit reality, the UK needs a specific listing methodology for AML and CTF to address ML/TF risks unique to the United Kingdom.

1.1. Literature review

The literature review highlights that there is no universally valid list for identifying high-risk countries for money laundering, as the designation depends on the perspective of the destination country where the funds are to be laundered. For example, the EU lists high-risk countries based on their

potential to serve as sources of illicit money to be laundered within the EU, not necessarily in their country of origin. This means that multiple valid lists of high-risk countries exist, and theoretically, there could be as many lists as there are list-making countries (destinations). Consequently, several different listing methodologies or interpretations of a country's risk level for money laundering may exist, leading to diverse high-risk country lists in practice (Riccardi, 2022; Savona & Riccardi, 2019).

1.2. The importance of anti-money laundering policy for counter-terrorist policy

AML policy is of paramount importance in countering terrorist activities due to the far-reaching impact of money laundering on various facets of society. Money laundering involves disguising criminal funds as legitimate assets and severely affects the effectiveness of the criminal justice system, destabilizes financial institutions, and poses a significant threat to the overall well-being and prosperity of a region's population. The perpetuation of financially beneficial criminal acts through money laundering perpetuates violence and establishes a pseudo-ownership over territories and their inhabitants. This situation prevents law enforcement agencies from tracing the origins of laundered funds and mitigating the indirect damages caused by criminal enterprises (Munro, 2014, p.14).

Notably, money laundering undermines confidence in the financial sector and leads to economic and social disruption. Its adverse impact extends to the integrity of the private sector, democratic principles, and the rule of law, posing a broader detriment to societal values.

Moreover, money laundering plays a pivotal role in facilitating terrorist financing, supporting illicit activities such as procuring weapons and materials for explosives (Souza, 2020). As a result, both money laundering and terrorist financing have significant economic, social, political, and security implications for countries and their citizens, elevating terrorism as a broader concern.

To effectively combat money laundering and terrorism financing, countries implement AML/CTF regimes, involving the enactment of laws, establishment of organizations, and implementation of systems to identify,

prevent, and disrupt such activities (Bruno and Díaz-Fuentes, 2020). International cooperation is crucial, with the exchange of information and coordination between nations being essential for identifying, investigating, and prosecuting those involved in these criminal acts (Souza, 2020).

In conclusion, the implementation of robust AML and CTF policies is indispensable in safeguarding society from the dire consequences of money laundering and terrorist financing activities (Tremblay, 2020).

1.3. The origins of the FATF and its role in anti-money laundering

The Financial Action Task Force (FATF) was established in 1989 as an inter-governmental organization to combat the growing global threats of money laundering and terrorist financing. Before the 1980s, money laundering was mainly dealt with at the national level, but with advancements in international banking, communication, and technology, it became a global issue (Oversby, 2004). The realization that money laundering could fund terrorism and other criminal activities led to the urgent development of international standards and guidelines to counter this threat (White, 1996).

The FATF, founded by seven original members, has grown to include 36 members representing countries worldwide and is the most influential global money laundering and terrorist financing standard-setting organization (Gilmore, 2017; Ouellet, 2017). It has developed initiatives and publications, including the influential FATF 'blacklist,' which identifies non-compliant countries with AML/CFT standards. Placement on the blacklist carries severe reputational, political, and economic consequences, incentivizing countries to comply (Webb & Tan, 2012; Gilmore, 2017).

To maintain global financial security, the FATF has created "best practice standards" known as the FATF 40 Recommendations, representing critical components of an effective AML/CFT system (Mendoza et al., 2013). The FATF also supports global capacity-building and technical assistance programs, facilitating international cooperation on AML/CFT matters (Reuter, 2018). It monitors the implementation of its standards through onsite visits and offers technical assistance to vulnerable countries (FATF, 2018).

In conclusion, the FATF serves as the baseline for nation-specific listings due to its global influence and overarching role in combating money laundering and terrorist financing (Mendoza et al., 2013). Its financial resources and expertise enable regular country assessments and policy reviews, solidifying its position as the global standard setter for AML/CFT measures.

1.4. FAFT Listing Methodology

Alternative listing methodologies, apart from FATF's, are developed based on different criteria for assessing and evaluating risks related to anti-money laundering and counter-terrorist financing. However, the FATF listing methodology and its High-Risk Third Countries (HRTC) lists remain the international standard for AML/CTF.

Over the years, the FATF has evolved its risk assessment approach, moving from a single list of non-cooperative countries in 2000 to two lists in 2023. The risk in 2000 was primarily based on the lack of cooperation between nations, while the current approach divides risks into a "Call for Action" list and a "Jurisdictions under increased monitoring" (grey list) (Riccardi, 2022, p.51).

For FATF, a country may be considered high-risk if it does not comply with FATF guidelines. Countries with deficiencies fall into two warning categories. The "grey list" comprises "Jurisdictions with Strategic Deficiencies," where countries need to improve anti-money laundering measures and cooperate with the FATF to achieve improvement. The second category, informally known as the "blacklist," is officially titled "High-risk Jurisdictions Subject to a Call for Action." These countries were previously on the grey list but have failed or refused to adopt recommended financial security procedures (FATF Countries, 2023).

Countries on the blacklist, also known as Non-Cooperative Countries or Territories (NCCTs), are advised by the FATF to implement the recommended measures. If they fail to do so, other countries are advised to apply enhanced due diligence measures in financial dealings with them, as such dealings may pose legal or fairness concerns (FATF Countries, 2023).

1.5. United Kingdom National Risk Assessment 2018

In response to the Financial Action Task Force (FATF) global AML/CTF standards, the UK government published its National Risk Assessment (NRA) on the illicit activity of money laundering (ML) and terrorist financing (TF) in October 2017 as part of its own review process. This assessment identified several areas of concern, including the current approach taken by FATF to HRTC listing, which the UK wants to review due to over-policing and its capacity to increase the risk of non-compliance with ML and TF regulations.

1.6. Criticisms of the FATF approach

In the National Risk Assessment (NRA), the UK government criticizes the current HRTC listing administered by the FATF, claiming it is fundamentally flawed and ineffective in achieving a harmonized approach to AML/CTF prevention and prosecution obligations. This viewpoint is shared by representatives from the United Nations (UN), who argue that the HRTC listing may increase the perceived risk of vulnerability to criminal activity for listed jurisdictions (UN, 2018).

The UK government contends that the HRTC listing introduces unnecessary complexity and additional resources to an already complex and expensive AML/CTF regulatory and supervisory regime, without adequately considering some jurisdictions' efforts to meet their obligations (HM Government, 2017). The listing is criticized for promoting an overly punitive approach for high-risk jurisdictions and a "naming and shaming" exercise that is challenging to remove even after rectifying the situation (HM Government, 2017). Additionally, the NRA warns of the potential for the HRTC listing to exacerbate tensions between countries, leading to an erosion of the global regulatory and supervisory system (HM Government, 2017).

Taylor (2017) highlights the concern that if one country or region is targeted or listed as HRTC, it could lead to retaliatory actions from other countries, reducing the overall effectiveness of the global AML/CTF framework. This can discourage countries that comply with AML/CTF regulations from reporting suspicious transactions due to fears of retaliation. The approach taken by the FATF regime is also criticized for being over-

generalized and not adequately addressing the specific risk differentiations associated with particular countries.

The central argument of this paper lies in the contrasting viewpoints between a collectivist approach, represented by the current HRTC listing, and a nationalized approach to listing high-risk countries (Taylor, 2017). The discussion revolves around finding a more nuanced and country-specific approach to address the shortcomings of the current listing methodology.

1.7. The concept of risk in AML and CTF regimes

A risk-based assessment is a crucial component of the UK's AML/CTF regime, as well as global efforts to combat money laundering. The regime aims to mitigate the risks of money laundering and terrorism financing by ensuring financial institutions and money service businesses (MSBs) comply with relevant regulations and standards.

The Financial Action Task Force (FATF) defines a risk-based approach as the process of assessing and understanding the money laundering and terrorist financing risks faced by an institution or organization and taking necessary measures to mitigate those risks (FATF, 2012). As part of the risk-based approach, financial institutions and MSBs in the UK are required to conduct risk-based assessments to identify and manage the risks associated with each customer. This assessment involves reviewing the customer's profile, the nature and purpose of the activity or transaction, and the customer's geographic location (HM Treasury, 2017).

Since 2012, the risk-based approach has become central to AML prevention measures worldwide. It requires entities to categorize customers into high, standard, and low-risk categories, and tailor AML measures accordingly. Higher money laundering risks necessitate enhanced measures, while lower risks allow for simplified ones (FATF, 2012).

Examples of risk-based measures may include enhanced customer due diligence, additional monitoring and record-keeping, or increased reporting requirements (HM Treasury, 2017). This approach helps allocate and focus AML efforts where the risk of money laundering is perceived to be the greatest (Wang & Wang, 2007; FATF, 2004).

In conclusion, the risk-based assessment plays a critical role in the UK's AML/CTF regime, guiding financial institutions and MSBs in identifying and managing money laundering and terrorism financing risks more effectively. It is an essential tool in the fight against financial crime on both national and global levels.

1.8. Unilateralism in a Post Brexit era and the UK's current listing methodology

Since leaving the European Union, the UK has updated its HRTC lists to comply with FATF standards and has undergone significant changes to its AML and CTF methodology. The adoption of the Fourth Money Laundering Directive (4MLD) introduced new measures to strengthen the prevention of money laundering and terrorist financing, including disclosing sensitive information about corporate structures to the General Register Office.

To align with FATF guidelines, the UK has introduced various new measures, such as a revised suspicious activity reports regime, tightened due diligence requirements, and increased efforts to detect and disrupt financial crime. The Joint Money Laundering Intelligence Task (JMLIT) has also improved its methods of gathering and analyzing financial information to better identify suspects and their networks, facilitating cooperation and intelligence sharing between different agencies.

Despite these efforts, there remain challenges within the UK's AML regime, including the presence of high-risk jurisdictions not currently on the HRTC list. The recovery of criminal funds remains relatively low, with 98% of funds remaining in criminal hands over the past 30 years. However, the UK has shown an increase in anti-money laundering efforts, with record illicit funds recovery and a substantial increase in suspicious activity reports reporting.

Pontes et al. (2021) point out four critical factors challenging the UK's AML regime, namely compliance culture, existing inefficiency, fragmentation of information, and an inability to process reports by authorities. These factors need to be addressed to further improve the effectiveness of the UK's

AML and CTF listing regime in combating money laundering and terrorist financing.

1.9. The compliance-based approach

The current approach to AML regulation in the UK heavily relies on compliance-based methods, which involve making financial institutions comply with specific rules and requirements. While this approach offers some advantages, such as flexible enforcement mechanisms, it also faces significant challenges.

One major issue is the limited financial resources available to organizations for compliance activities, leading to inadequate monitoring and reporting of suspicious activities. This hinders the ability to identify and address money laundering effectively. Additionally, the compliance-based approach has been criticized for being too process-oriented and bureaucratic, lacking consideration for stakeholders' realities and needs.

The inflexibility of compliance-based approaches may overlook underlying risk factors associated with money laundering, failing to consider the insights and contributions of financial institutions in developing more effective compliance measures. As a result, the current approach is perceived as reactive rather than proactive in combating money laundering and terrorist financing.

To improve the effectiveness of AML regulation, the UK needs to address the limitations of the compliance-based approach and consider more risk-based and proactive measures to prevent and deter criminal activities related to money laundering.

1.10. The Fragmentation of Information

Fragmentation within the UK's current AML regime creates significant challenges. It hinders effective coordination among regulatory actors and oversight of the financial system, leading to inconsistencies in analyzing potential risks and threats. Financial institutions and responsible firms face additional burdens in managing multiple, sometimes conflicting, legal obligations.

The lack of a centralized framework and authority for policing AML issues further exacerbates the problem. Introducing a central UK-based framework could help address these challenges and improve the enforcement of meaningful regulatory oversight while enhancing financial institutions' ability to identify and evaluate AML risks accurately.

1.11. Inability to process reports

The UK's AML regime faces challenges in processing reports due to its complex and time-consuming nature, as well as the ever-increasing rate of regulation issuance. The regime lacks consistency, with reporting periods varying across trade sectors and individual reports often not providing enough data for accurate evaluation. As a result, relevant authorities struggle to effectively measure the country's financial crime level and face difficulties in processing reports efficiently. A more consistent and streamlined approach is needed to address these issues.

2. A National or Supra-national approach to Listing Methodologies

Within this section, the paper will engage with the broader debate between national and supra-national approaches to listing methodologies.

The primary debate revolves around whether countries should adopt a nationalized approach or follow the FATF's global strategy when listing HRTCs. The nationalized approach involves countries going beyond FATF requirements to identify and list high-risk and uncooperative actions according to their own criteria (Blanco-Alcivar et al., 2020). Critics argue that this approach lacks transparency and may be exploited for political purposes (Li & Lokshin, 2017).

On the other hand, the global FATF approach requires international multilateral coordination and cooperation to address HRTCs (Sang et al., 2016). However, this approach also faces risks of misuse by certain countries and lacks representation from a diverse range of nations (Li & Lokshin, 2017).

The UK's specific needs highlight inadequacies in the FATF HRTC regime. The current approach relies on a "box ticking" method, assuming countries not meeting stringent criteria as high-risk, failing to consider the complexity of money laundering and terrorist financing risks. This approach leaves the UK vulnerable as a global financial hub to money laundering effects. Additionally, some countries that pose threats to the UK may not be prioritized in the FATF risk assessment, necessitating the UK to consider its specific banking relationships and global position (Fazekas et al., 2017).

The lack of specificity in the global HRTC framework negatively impacts the UK's financial prowess, particularly its ability to attract foreign direct investments (FDI) (Mollov et al., 2018). The UK's dependence on the static FATF list prevents it from dynamically responding to changes in the global environment and adapting to its own listing requirements.

Transparency is a major concern with the global approach, as the FATF listing regime may not always lead to meaningful actions, making it difficult for the UK to justify risk-based precautions (Thorburn, 2020). Moreover, certain countries may misuse the FATF system for their strategic interests, impacting global trust and stability (Boswell, 2020).

To address these issues, the UK needs its own HRTC listing regime with stringent criteria to prevent foreign interference and ensure effective AML and

CTF regulations (Root, 2020). Establishing a transparent and accountable methodology will build trust and foster healthy relationships with non-cooperative jurisdictions through diplomatic means (Blanco-Alcivar et al., 2020).

The evolving listing methodologies in the EU and the specific risks the UK faces further highlight the necessity for a unique national approach rather than a one-size-fits-all global strategy (Blanco-Alcivar et al., 2020).

In conclusion, the debate over the nationalized approach versus the global FATF strategy centers on addressing country-specific risks and political abuses. The UK's specific inadequacies with the current regime highlight the need for a customized listing system, providing transparency and control while building trust with other nations. This shift towards a more localized approach aligns with the changing paradigm of listing regimes.

3. The regional regime model: An Evaluation of the EU Revised Listing Methodology of 2020 and its applications towards the UK

The 2020 revised EU methodology for identifying HTRCs diverges from the global FATF HRTC regime in several key aspects. The EU's approach involves additional listing criteria and risk-based assessments while still aligning with FATF standards as a baseline. The EU methodology identifies risks for money laundering or terrorist financing through strategic and structural deficiencies and emerging threats (Stoldt, Freyberg, and Vatzak, 2021).

The EU classifies countries into four risk levels (low, medium, high, and very high risk) based on a holistic and risk-based approach that considers intelligence data and other information sources, including FATF ratings. In contrast, the FATF HRTC regime does not factor in a country's population or engagement in specific criminal activities, limiting its application (Harold et al., 2015).

The EU's focus on counter-terrorism reform is also evident in its new counter-terror agenda since 2005, aiming to develop a strategic vision for counter-terrorism and enhance the EU's credibility as a security provider (D'Amato & Terlizzi, 2022).

Moreover, the EU's due diligence process for countries at very high risk is more stringent than the FATF regime, involving evaluation by all member states before inclusion on the high-risk list. The FATF does not mandate additional requirements for countries at very high risk beyond those for all HTRCs.

3.1. Why the EU's revised HRTC Listing methodology is inappropriate for the United Kingdom

The EU 2020 revised AML/CFT regime and its proposed HRTC listing methodology have faced criticism in the United Kingdom (UK). The revised AML/CFT regime relies on a 'one-size-fits-all' approach through the European Commission's (EC) Risk-Based Supervision (RBS), which is considered unsuitable for the diverse needs of EU Member States and does not encourage modernization and innovation in financial institutions (Cretney, 2015).

The proposed HRTC listing methodology diverges from the risk-based cooperation approach of the FATF and suggests countermeasures against specific states or entities, potentially causing diplomatic damage. The arbitrary and opaque nature of the listing process, along with punitive countermeasures introduced unilaterally by the EU, undermines trust in the process (Pavlidis, 2022).

Furthermore, the EU's methodology fails to recognize the specific achievements and strengths of the UK's AML/CFT legislation. The UK has received 'enhanced status' from the FATF and is considered to have one of the most advanced AML/CFT regulations (Vu & Piazza, 2017).

Considering these issues, if the UK were to adopt the EU's new methodology, it would need to address the lack of transparency in its listing process and find a balance that recognizes its existing achievements in AML/CFT regulations.

3.2. What can the UK draw from the EU's Revised Methodology?

The aim of the EU 2020 Revised HRTC listing methodology is to restrict access to the EU's financial system and address loopholes facilitating money laundering and terrorist financing. The EU's methodology addresses the increasing prevalence of virtual asset service providers (VASPs) in listed countries, entities that can be used to disguise criminal wealth transfer or funds for terrorism. The EU imposes stricter rules on customer due diligence and beneficial ownership information to mitigate this risk.

Incorporating this aspect into the UK's economic crime plan would help close gaps between VASPs and financial crime. Additionally, the EU's methodology requires listed countries to establish effective AML/CFT frameworks within the EU's regulatory framework. Implementing this in the UK would ensure adequate safeguards for the financial system and enable data sharing and access to EU resources.

The methodology provides a comprehensive risk assessment of third countries, considering political, economic, social, and judicial risks. By using this data, the UK can better identify high-risk jurisdictions and associated threats to its financial system, enabling the refinement of analytical tools and methodologies to handle these risks effectively.

4. Conclusion

In summary, this paper argues that the UK needs to expand its own listing methodology and regime instead of solely relying on the FATF list. The current prescriptive regime, based on FATF recommendations, is inefficient and fails to address the UK's specific ML/TF risks. By adopting a more nationalized approach, the UK can proactively address its security concerns and reduce the compliance culture that hinders its system.

Though developing its own regime may incur costs, it can be a money-saving venture in the long run by tackling inefficiencies. However, the UK's size as compared to larger entities like the EU might limit its practical capabilities in establishing and maintaining its regime.

Developing its listing system opens the UK to criticism of politically motivated actions. The FATF's international standard is seen as neutral, but it is contested in the literature, indicating political use by states.

The EU's 2020 Revised methodology, like the FATF system, follows a one-size-fits-all approach and lacks transparency in the listing process. Its additional criteria and countermeasures become diplomatic liabilities. Nevertheless, the methodology provides insights into modernization needs, such as addressing VASPs, which would be crucial for the UK's future listing regime.

In conclusion, the paper's hypotheses are affirmed: there is a growing shift towards nationalized approaches, necessitating the UK to develop its own listing, informed partly by the EU's methodology but uniquely tailored to meet its specific needs.

4.1. Evaluation

The paper heavily relies on secondary sources, such as academic articles, governmental reports, and online databases, to conduct its analysis of the debate between global and national approaches to listing methodologies. While this approach is suitable for a dissertation with limited funding and time constraints, it also means that the analysis is subjective to the researcher's interpretation of the selected sources. While the paper presents a well-structured argument and effectively analyzes the pros and cons of both

global and national approaches, the use of primary data collection, such as interviews with sector experts and government officials (Home Office and HM Treasury), could enhance the depth and accuracy of the research.

4.2. Practical Recommendations for Future Research

Future research should consider incorporating primary data collection through interviews with sector experts and government officials (Home Office and HM Treasury). Such interviews offer several benefits, including in-depth and detailed knowledge, the ability to explore expert understanding and expertise in greater detail, and direct questioning of motivations, leading to a better contextual understanding of specific issues. Additionally, expert interviews can generate deeper analysis and understanding compared to surface-level views obtained from quantitative surveys. By utilizing qualitative interviews, researchers can mitigate their own bias and ensure that the focus of the research does not unduly influence the findings, thus allowing the argument and recommendations to better reflect reality.

4.3. Other Gaps in the Literature to be Explored

Future research could explore the concept that AML/CTF represent a "forced marriage" of two distinct issues with fundamentally different characteristics. Money laundering and terrorist financing have critical differences in sourcing and intent for funds, with terrorism financing driven by ideological ends rather than financial gain. Despite these differences, measures against money laundering and terrorism financing are often addressed simultaneously. By recognizing and disentangling these issues, policymakers can develop more targeted strategies against each form of financial crime.

Addressing the discrepancies in the measures against money laundering and terrorism financing could lead to more tailored and efficient policies for combatting both crimes. The paper suggests that further research into this area could shed light on the incompatibility of AML/CTF measures, pointing out the differences in intent and motivations behind these crimes. Separating

these issues and adopting more focused strategies would allow for a more nuanced and effective approach to tackling financial crimes in the UK.

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