# *Australia's New Anti-Money Laundering Strategy*

Stuart Ross and Michelle Hannan*

***Abstract***

In 2006 the Australian Government undertook major reform of the regulatory framework to detect, prevent and prosecute money laundering. These reforms were responses to the changing nature of money laundering as well as the limitations inherent in the existing compliance or rule-based regulatory approach. Originally intended to deal with the laundering of cash generated mainly by drug trafficking, contemporary anti-money laundering systems must now deal with a range of 'public bads', including organised fraud, the financing of terrorism, corruption and the theft of state assets, and the financial weaknesses of 'failed states'. Existing regulatory systems have generated unwieldy volumes of defensive reports of suspicious transactions, but little in the way of tangible outcomes. Australia's money laundering regulatory deficiencies were highlighted by an evaluation review conducted in 2005 by the Financial Action Task Force. This article considers how the new *Anti-Money Laundering and Counter-Terrorism Financing Act* 2006 (Cth) addresses these regulatory deficiencies. It examines the change from a compliance to a risk-based approach, increased customer due diligence requirements and their impact on bank privacy and related issues, and how the new regulatory framework is likely to impact on the role of the Australian Transaction Reporting and Analysis Centre (AUSTRAC) and its relationship with financial institutions and other reporting entities.

## Introduction

When Tony Mokbel fled Australia some time in March or April 2006, there were probably few in the criminal justice community who were surprised. Mokbel was known to be a key player in drug importation, trafficking and manufacturing. His flight came just before the conclusion of a Victorian Supreme Court trial on charges of importing 2 kilograms of cocaine, on which he was convicted and sentenced *in absentia* to 12 years in prison. He also faced the possibility of being charged with murder or murders arising out of the gang wars over control of drug distribution in Melbourne. The immediate result of his flight was that a surety of $1 million put up by his sister-in-law was declared forfeit. Her appeal against the forfeiture order on the grounds of financial hardship was complicated by the discovery by police of cash and jewellery valued at $500,000 buried in the backyard of her uncle. Another consequence of the criminal proceedings against Mokbel was the seizure by the Supreme Court of a range of assets including investment properties, cars and motorcycles,

* Melbourne Centre for Criminological Research & Evaluation, School of Political Science, Criminology and Sociology, University of Melbourne.

jewellery and bank accounts with a total value of several millions. However, the assets seized by the courts do not appear to have constituted the main part of Mokbel's criminal fortune. According to police, his flight was preceded by the transfer out of Australia of at least $20 million. Over time, more and more Mokbel assets have come to light, and it is now estimated that his personal fortune may have exceeded $40 million. Mokbel was eventually tracked down to a luxury apartment in Greece, but it remains to be seen whether his criminal fortune will be as easy to trace.

All of this fits the standard lifestyle script for a successful drug baron. A central element in maintaining this lifestyle is the conversion of cash generated by illicit activity (in Mokbel's case, mainly drug manufacturing and trafficking) into consumer goods, investments in property and businesses, and funds held within the legitimate financial system. This process of converting illicitly acquired funds into apparently legitimate funds or possessions is known as money laundering. Money laundering serves several purposes: it makes illicitly acquired money available for legitimate expenditure or re-investment in further illegal activity. It disguises the origin of the funds so that they are protected from seizure if the illegal activity is detected. Finally, it makes the funds available for transfer to other individuals or places through the international banking system.

Effective anti-money laundering (AML) strategies and practices are therefore critical in detecting and preventing cash-based illicit activity like drug trafficking. However, to date, Australia has not had an effective regulatory regime for the control of money laundering. A review of Australian AML conducted by the Financial Action Task Force (FATF) in 2005 found gaping holes in Australian legislation and practice (FATF 2005:75). The review reported that Australia was not compliant with around one-quarter of international AML standards. There were also serious gaps in the AML regulatory and enforcement system. The resources available to the main regulatory agency (the Australian Transaction Reporting and Analysis Centre – AUSTRAC) were insufficient, and AUSTRAC did not have adequate enforcement powers to ensure compliance. The end result was that only a handful of individuals engaged in money laundering were ever prosecuted and convicted.

In December 2005 the Australian Government released the exposure draft of the Anti-Money Laundering and Counter Terrorism Financing Bill (2005), followed by a revised draft Bill in June 2006. The Bill was passed into law in December 2006, although significant elements in the reform package have yet to be finalised. The first tranche of the Act, covering the financial sector including banks, credit unions, building societies and trustees, casinos and other gambling service providers and bullion dealers, came into force in December 2006. A second tranche covering real estate agents, dealers in precious metals and precious stones and a range of non-financial transaction provided by accountants, lawyers and trust and company service providers will come into force in 2008.

The new Act represents the Australian Government's response to changes in the international anti-money laundering (AML) and counter terrorism financing (CTF) regulatory environment as well as a response to the criticisms raised by the FATF review. This article considers some of the criminal justice and regulatory policy issues that arise out of the anti-money laundering components of the Act. It examines how the Australian AML reform package reflects the changing nature of money laundering both at a local level, and in trans-national financial and criminal systems. A key change in the international regulatory regime is the shift from 'rule-based' to 'risk-based' regulation, and we consider what implications this has for the relationships between the regulators, the financial industry and users of the financial system. The Act greatly extends the scope of AML legislation to cover a range of non-cash 'financial products', remittance services,

correspondent banking arrangements, designated services outside the financial services sector, and overseas-based branches or subsidiaries of Australian institutions with reporting obligations, and we consider how these changes may affect the operation of the new regulatory regime.

The new Act includes a range of provisions directed at the financing of terrorism. These CTF provisions also raise important policy and practice issues, but we see these as requiring a separate analysis. Indeed, it can be argued that the decision to include both anti-money laundering and counter-terrorist financing provisions in a single Act represents a degree of policy confusion that is itself an important issue.

## Money Laundering in Australia

Reliable data on the extent of money laundering in Australia is hard to come by. A basic problem is that few offences identifiable as money laundering are recorded in State, Territory or Commonwealth crime statistics,[1] and only a handful of money laundering offences are ever prosecuted. AUSTRAC, the agency involved in the bulk of AML regulatory activity, provides vast amounts of information to law enforcement agencies on suspicious transactions – State, Territory and Commonwealth agencies conducted over a million searches of the AUSTRAC database in 2004-05 and AUSTRAC produced nearly 1000 intelligence assessments over the same period – but only a tiny proportion of these result in any form of prosecution (AUSTRAC 2005). The FATF review reported that there had been 13 prosecutions under the Commonwealth *Proceeds of Crime Act* 2002 between 2003 and 2005, resulting in five convictions (FATF 2005). Money laundering can also be dealt with by asset confiscation, and the FATF review reported there had been 70 such confiscations in 2003-04, of which they estimated 10% to 20% involved money laundering.

An alternative approach to measuring the level of money laundering is to model the flow of funds from the underground economy to the legitimate economy (for a detailed explanation of this method, see Unger et al. 2006). An Australian study using this methodology estimated that between 1 and 4 1/2 billion dollars of illegal funds were laundered in or through Australia each year (AUSTRAC 1995). The FATF review team settled on an estimate of 2 to 3 billion dollars for Australian money laundering. By way of comparison, the global value of money laundering is estimated at between 3 and 5 trillion dollars.

The contemporary international anti-money laundering regulatory system has its origins in US law enforcement agency responses to the development of large-scale drug trafficking in the 1970s and 1980s (Reuter & Truman 2004), and drug trafficking is often seen as the quintessential predicate crime for money laundering. However, it is now widely recognised that fraud (including tax fraud) is also a major predicate crime that generates money laundering. While there is considerable effort expended in monitoring the nature and level of drug trafficking in Australia (see e.g. the annual Illicit Drug Data Report series produced by the Australian Crime Commission), there have been few detailed studies of the nature and extent of fraud in Australia. Fraud is a notoriously under-reported crime and estimates of the volume and value of fraud are therefore unreliable. A UK study by KPMG Forensic

---

1 This is partly a definitional problem. Money laundering was originally a specific offence under s81 of the *Proceeds of Crime Act* 1987 (Cth). When this was replaced by the *Proceeds of Crime Act* 2002 (Cth) this offence was moved to Div 400 of the *Criminal Code Act* 1995 (Cth) where it became seven separate offences of dealing with the proceeds of crime (classified by value of the dealings).

reported that fraud was split roughly equally between 'insider' frauds carried out by management or company employees, and frauds by professional criminal gangs (KPMG 2003).

The most commonly used money laundering methods in Australia involve the mainstream banking and financial system. Where the predicate crime is drug trafficking, the large volumes of illicit cash that are generated are deposited in banks, often in small amounts distributed across a number of accounts ('smurfing') or integrated into the cash-flows of legitimate cash-intensive businesses. Casinos and other forms of gambling also offer the means to launder cash. Money launderers use illicit cash to purchase gambling tokens which are in turn traded for casino cheques. Where the predicate crime is fraud, funds may enter the financial system directly in the form of disguised income (tax evasion), or fraudulent benefits or payments for goods or services. Once inside the financial system, money launderers may disguise the source of funds by shifting them across a number of accounts – which may be established in false or stolen identities – and this 'layering' process may involve moving funds out of the country either permanently or temporarily. While most of these laundered funds have their source in illicit activity within Australia, there is also evidence that criminals operating in other countries transfer funds into Australia for laundering (FATF 2005). While it is known that money launderers look for stable, rewarding sites as ultimate destinations for laundered funds, Australia was not in the top 20 destinations for laundered money that were identified by Walker (1999). The FATF has noted the growing use of professional money launderers, and while there is little direct evidence of this in Australia, this may simply reflect the fact that unsophisticated 'do-it-yourself' laundering is most likely to come to regulatory attention.

## A Brief History of the International AML Regulatory Regime

Anti-money laundering regulation has three goals. The presence of money laundering is a signpost to the illegal activity generating the funds, and by detecting money laundering we can know who is engaged in illegal activity, when it occurs and its extent. This knowledge in turn assists law enforcement and justice agencies to detect and punish offenders. A second goal is to prevent criminals from realising the financial benefits of their crimes by adding to the costs and reducing the benefits of crime. Effective anti-money laundering may mean that criminals have to 'discount' the value of the cash they receive (e.g., by paying fees to specialist money launderers) and prevents criminal enterprises from buying or otherwise controlling legitimate enterprises. Another way that effective AML adds to the costs of crime is by forcing criminals to engage in high risk activities like cash smuggling. Finally, anti-money laundering protects the integrity of the legitimate financial system by keeping illegal funds out. This is particularly important in the case of small states whose financial systems are vulnerable to illicit funds flowing in from outside, or the loss of revenues or assets generated within the state as a result of corruption or theft.

The international AML regulatory regime is coordinated by the FATF, an inter-governmental body established at the G-7 Summit in Paris in 1987 to develop and promote policies to combat money laundering and the financing of terrorism. The primary mechanism in the FATF armory is the 40 Recommendations, a framework of regulatory and enforcement processes and countermeasures (FATF 2004). Originally drawn up in 1990 mainly to combat money laundering associated with the trade in illicit drugs, in recent years the scope of the 40 Recommendations has been extended and supplemented by Nine Special Recommendations directed at combating the financing of terrorism. The FATF regulatory framework is backed by a powerful monitoring and evaluation process. Countries that do

not endorse the FATF framework or that fail to actively support it with legislation and enforcement are likely to be placed under pressure through international bodies like the International Monetary Fund and World Bank, and find that their financial institutions are subject to restrictions on their trading relationships with FATF-compliant states. In addition to FATF, there are also a variety of regional bodies such as the Asia Pacific Group on Money Laundering that play supporting or facilitative roles. While FATF provides a regulatory umbrella, the responsibility for enforcement rests with national financial intelligence units (FIUs) operating in conjunction with law enforcement agencies.

Since it was first established, the international AML regulatory regime has been through a series of reforms driven by changing concepts and concerns about money laundering as a national and international problem. We see three changes in the regulatory environment as central to understanding the reforms to Australia's AML legislation and regulatory mechanisms.

### *Changes in the Concept of Money Laundering*

The primary driver for the creation of anti-money laundering regulation was the desire to combat large scale drug trafficking and the organised criminality associated with the drug trade. A basic problem for drug traffickers (and hence an obvious point of vulnerability) is the need to move large volumes of cash into the legitimate financial system. In addition, the source and destination points for illicit funds derived from drug trafficking are fairly obvious. While early AML strategies were based on an 'unsophisticated market model' of money laundering (Reuter & Truman 2004), they did have the advantage that their focus on drug trafficking meant that regulators were presented with well-defined targets who used a fairly simple placement-layering-integration methodology.

However, over time the focus of AML has become progressively broader as money laundering methods have become increasingly complex. As noted earlier, one of the largest sources of illicit funds is fraud. Since fraud frequently involves individuals who are already 'within' the financial system, this kind of activity is inherently much more difficult to detect. The individual who coordinated the laundering of over US$20 million in ENRON funds was the company's Chief Financial Officer, and he was able to use the company's existing relationships with Cayman Islands' banks to move the money (Johnson 2002). More recently, the AML regime has been co-opted as the way to address a range of problems that Reuter and Truman describe as 'public bads': the financing of terrorism, corruption and the theft of state assets, and the financial weaknesses of 'failed states' (Reuter & Truman 2004:139). This expansion in the range of problems that the AML regime is required to deal with has led to increasing regulatory complexity, greater demands on financial agencies, more direct involvement of the financial sector and a lack of focus in both regulation and enforcement (Cuellar 2003; Bosworth-Davies 2006).

### *Regulatory Problems Arising from Rule-Based Regulation*

A primary driver of regulatory reform has been the recognition that prescriptive or compliance models for regulation give rise to their own problems and are not an effective basis for dealing with the dynamic nature of contemporary money laundering. AML regulatory regimes based on compliance with prescriptive rules result in 'defensive reporting' by financial agencies with the result that regulatory agencies are swamped by the volume of Currency Transaction Reports (CTRs) and Suspicious Activity Reports (SARs) generated by agencies with reporting obligations (KPMG 2003). A flow-on effect is that this overload compromises the investigative capacity of FIUs (Reuter & Truman 2004). A recent review of the UK SARs regime found that reporting was uneven and frequently of

poor quality and imposed excessive burdens on the National Criminal Intelligence Service. As a result, there was a failure to exploit the information generated in ways that had a significant impact on crime (Lander 2006). These criticisms mirror the causes of failure for prescriptive regulatory approaches in general: over-regulation leading to excessive compliance costs, inflexibility and consequent poor regulatory performance, and a focus on legalism rather than regulatory effectiveness (Hutter 2005).

### *Money Laundering and Globalisation*

Yet another failing of the prescriptive regulatory approach has been its inability to respond flexibly and sensitively to the changes in money laundering methods associated with technological developments and globalisation. Money launderers, in common with other criminals, are constantly on the lookout for opportunities and vulnerabilities thrown up by the rapidly evolving international financial system. The internet has created a range of new money laundering opportunities through internet banking, gambling and e-commerce. The speed, anonymity and transnational nature of the internet make it ideally suited for money laundering, and these same characteristics also mean that detection and enforcement are rendered more difficult (Phillipsohn 2001). The same concerns apply to the use of electronic currency in the form of stored value cards and other forms of electronic money (He 2004).

## Problems with the Australian Regulatory Regime: The FATF Mutual Evaluation Report

Under the Australian federal system, the Commonwealth Parliament is responsible for the regulation of banking while the States and Territories have primary responsibility for the administration and enforcement of the criminal law.[2] The consequence of this division is that the Australian regulatory framework for dealing with money laundering is complex and relies on the successful interaction of national and State and Territory legislation. Money laundering was first criminalised in Australia in 1989, and the provisions of Div 400 of the Commonwealth *Criminal Code Act* 1995 remain at the core of the Australian AML system. This primary legislative mechanism is supplemented by the *Financial Transactions Reports Act* 1988 (Cth) (the 'FTR Act'), the *Proceeds of Crime Act* 2002 (Cth), and the *Suppression of the Financing of Terrorism Act* 2002 (Cth). The effectiveness of this regulatory framework was put to the test in 2005 when Australia was the subject of a FATF 'Mutual Evaluation' conducted by a team from FATF and the Asia Pacific Group on Money Laundering (APG). Mutual evaluations are an assessment of national legislation, regulatory and enforcement arrangements by teams of international assessors appointed by FATF. The results of the 2005 evaluation were not encouraging.

Perhaps the single most significant deficiency in the Australian AML regulatory regime identified by the FATF/APG team was that it did not produce tangible results in the form of charges and convictions. Very few money laundering offences are brought to court in Australia, and even fewer convictions are secured. FATF interpreted this as indicating that 'the regime is not being effectively implemented' (FATF 2005:6). Some of the reasons for Australia's low rate of law enforcement action in relation to money laundering are discussed below, but for the moment it is sufficient to note that this problem is apparent in many AML regimes around the world (Reuter & Truman 2004:108-118) and that the goals of AML regulation may be served as well or better by prevention.

2 Although note that the *Criminal Code Act* 1995 (Cth) includes a range of criminal offences including people smuggling, espionage, treason and sedition, terrorism, and a variety of general criminal offences.

At least some of Australia's poor regulatory performance is caused by the failure of Australia's AML regime to keep up with the standards specified in the FATF 40 Recommendations. While the Australian regulatory regime had been compliant with earlier versions of the FATF 40 Recommendations, it had failed to introduce the reforms necessary to meet the more stringent FATF framework that was issued in 2003. The review found that Australia was non-compliant in relation to one-quarter of the 40 Recommendations, and only partially compliant in relation to 14 other Recommendations. The main areas of non- or partial-compliance identified by the mutual evaluation team were:

- *The limited range of institutions covered by legislation.* Essentially, only financial institutions as defined by the FTR Act were required to exercise customer due diligence (CDD), monitor account use and report on individual transactions. The legislation did not cover a range of institutions that may be targets for money launderers, including securities and insurance institutions, fund managers, foreign exchange dealers and money remitters.
- *Inadequate customer due diligence requirements.* Procedures for identifying customers were 'complex and indirect'. The 100-point identification system was based on documents some of which are of questionable reliability, and provided for an 'acceptable referee' alternative to documentary identification that was unacceptable to FATF. A variety of transaction types and customer types were not covered by CDD requirements, nor was there a requirement for ongoing CDD for existing customers.
- *Inadequate record keeping for international funds transfers.* While there was mandatory reporting of all international funds transfers, there was no requirement to identify the originator of the transfer, for intermediary institutions to hold originator information, or for domestic transfers to record originator information.
- *No prohibition on dealings with 'shell banks'.* There were no legislative prohibitions on financial institutions from entering into, or continuing correspondent banking relationships with 'shell banks' (i.e., banks that have no physical presence in the country where they are incorporated and licensed).
- *Inadequate coverage of transactions involving high risk or non-FATF compliant countries.* There were no legislative requirements for financial institutions to pay special attention to transactions to or from high risk or non-FATF compliant countries. Foreign branches and subsidiaries of Australian financial institutions may be prevented by local laws from implementing all Australian AML requirements, and were under no obligation under the FTR Act to do so.
- *No regulation of risks associated with new technologies or non-face to face business.* There were no requirements for the prevention of the misuse of technological developments, or for effective CDD procedures that apply to customers who have no direct physical contact with financial institutions.
- *No coverage of politically exposed persons.* There were no legislative or other enforceable obligations relating to the identification or verification of politically exposed persons (i.e., individuals who are or have been in prominent political positions in a foreign country, or their close relatives or associates).
- *A focus on compliance rather than risk.* Overall, the Australian AML regime did not require that institutions take into account risk in the way they develop or implement AML procedures.
- *Inadequacies in legislation covering the financing of terrorism.* Legislation did not specifically cover the collection of funds for terrorist organisations, the provision of funds to individual terrorists, or the seizure of assets of terrorists or those who finance them.

While the evaluation team found that AUSTRAC was 'an effective FIU', it pointed to the low rate of compliance inspections conducted by AUSTRAC, the lack of administrative sanctions for non-compliance, and poor coordination between AUSTRAC and the Australian Securities and Investment Commission and Australian Prudential Regulation Authority. Overall, 'the evaluation team did not find the implementation of the AML/CTF supervisory system to be effective in terms of the standards required by the revised 40 Recommendations' (FATF 2005:10), and called for additional resourcing of AUSTRAC to enable it to effectively fulfil its obligations.

Some of the reforms recommended by the FATF/APG team (e.g., the change to risk-based regulation and enforcement) represent changes in the international AML regulatory approach that Australia has not yet caught up with. Other deficiencies can be traced back to the changes in the nature of money laundering that were outlined earlier. The FATF/APG team's concerns about politically exposed persons, involvement with high risk countries and terrorist financing arise from the extension of the AML regime to other 'public bads' that it was not originally intended to deal with. Similarly, their concerns about the regulation of non-face to face transactions and other technology-related risks arise from the impact of globalisation and technology change.

## Reforms to the Australian Regulatory Regime

At least some of the inadequacies in Australia's AML regime were apparent before they were confirmed by the FATF/APG review team. Within a few months of the publication of the evaluation report in October 2005, an exposure draft of an Anti-Money Laundering and Counter-Terrorism Financing Bill was released for consultation. The key changes introduced in the new Bill were that it increased the range of activities covered by AML/CTF legislation to include all businesses or professionals involved in the provision of financial services, gambling or bullion dealings; linked counter-terrorism financing and anti-money laundering systems; gave AUSTRAC an enhanced enforcement and monitoring role; and required that entities covered by the legislation develop and implement programs to identify and materially mitigate the risk of money laundering or the financing of terrorism.

During the first half of 2006 the government received submissions on the exposure draft (Parliament of Australia 2006), and in November a redrafted Bill was presented to the House of Representatives, becoming law in December of that year as the *Anti-Money Laundering and Counter-Terrorism Financing Act* 2006 (Cth). It is not proposed here to review the contents of the Act in detail, but rather to examine three of the most significant changes to the nature of the Australian AML regulatory environment that will flow from the new legislation. These changes are:

1. the change from a compliance to a risk-based approach;
2. the changes to CDD requirements and their impact on bank privacy and related issues; and
3. the changes to AUSTRAC's role and its relationship with reporting entities.

## The Change to Risk-Based Regulation

As noted earlier, the risk-based approach in AML regulation in general, and in the Australian AML/CTF Act in particular, are part of a general shift in regulation away from prescriptive, compliance-based approaches. In recent years the concept of risk as an organising principle for AML has shown up in the Basel regulatory framework, the revised

FATF 40 Recommendations and the EU Third Directive on Money Laundering. Risk has always been integral to ways of thinking about money laundering, but contemporary AML approaches place risk, risk assessment and risk management as central elements in regulatory strategies. The change to a risk-based approach represents a fundamental conceptual shift and raises a number of theoretical and practical issues that must be resolved if these strategies are to work effectively. Two requirements for effective risk-based regulation are agreement about what risks are being 'identified, managed and mitigated', and providing those responsible for developing and refining risk-based decision models with knowledge to understand these risks and the outcomes of assessments and investigations.

### *Agreeing on What Risks Should be the Basis for Regulatory Decision Making*

The concept of risk appears in a variety of guises within the AML/CTF Act. Reporting entities are required to design and implement programs to 'identify, mitigate and manage' risks associated with the provision of designated services (s84). In the event that AUSTRAC is not convinced that appropriate action to identify, mitigate and manage risk is being taken, AUSTRAC can require that a risk assessment be carried out (s165) or that an external auditor be appointed to carry out a risk assessment (s161). Financial institutions are also required to carry out regular risk assessments in relation to correspondent banking relationships (s97ff). Modified customer due diligence procedures can be used in relation to certain low risk services (ss31 and 32). Notwithstanding the salience of risk as an organising principle in the legislation, it is noteworthy that in 20 pages of definitions at the commencement of the Act, the term 'risk' is not defined. Risk is conceptualised mainly in terms of the probability or likelihood that a transaction involves money laundering or terrorism financing:

> The risk-based approach recognizes that it is impractical to apply an equal level of vigilance to every customer transaction. Instead, it encourages directing resources and effort towards customers and transactions with a higher potential for money laundering (Attorney-General's Department 2004:11).

It cannot be assumed that financial agencies and regulators will approach the problem of risk assessment and risk management from the same perspective. Money laundering covers a wide spectrum of activities. It may involve high value or low value transactions, regular or irregular activity, and have flow-on consequences of varying significance. Existing systems used by banks and other financial institutions for assessing risk associated with fraud and credit are based on their potential financial consequences to the financial institution. While financial institutions are readily able to make assessments about credit and fraud risk, assessing money laundering risk in financial terms is notoriously difficult. However, in the case of money laundering and terrorism financing, the important risks are not those of direct financial loss to the institutions, but rather the reputational risks to the financial institution and the consequential risks to the community generally that flow from the failure to prevent these activities (McCusker 2005). For regulatory agencies, regulatory risk or the vulnerability of the regulator to accusations of being negligent or ineffective may be equally or more important. In the UK Financial Services Authority regulatory model, the factors leading to increased enforcement attention include weaknesses across entire divisions or branches within an organisation, multiple breaches within an organisation, or a failure to take remedial action following failures or breaches. Enforcement is 'targeted at the systems and control failures that pose the greatest risk' (Proctor 2005:12).

An important principle of risk-based regulation is that the businesses or agencies that are the subject of regulation need to be able to say how risk will be identified and measured.

Risk-based regulation transfers responsibility from regulatory institutions to financial institutions that have the specialised knowledge, experience and tools to design and implement effective regulatory strategies (Pieth & Aiolfi 2003). However, it is not at all clear how far AUSTRAC is prepared to go in ceding responsibility to the regulated. One of the key concerns from the financial services industry about the draft Bill was that it was overly prescriptive. In their submissions to the Senate Legal and Constitutional Legislation Committee, industry bodies noted that 'there are areas of the Exposure Bill where prescriptive and mandatory requirements have replaced a risk-based approach, with very little scope left for industry guidelines' (Parliament of Australia 2006:23).

### *Information Sharing about Risk Outcomes*

A critical requirement in designing and operating a risk-based regulatory system is that those responsible must know about the outcomes and consequences of risks that they identify. For example, in risk-based industry safety programs, the industry must know what would have happened had risky practices not been rectified, and what did happen when risks were not identified in an accurate or timely fashion (Haines 2003). Knowledge about outcomes and consequences allows risk assessment systems to be refined on the basis of feedback about their performance.

In contrast, existing AML regulation involves a clear division between the industry bodies that collect and refer information about suspected cases and the regulatory and enforcement agencies that process this information. Only a small minority of suspected cases are actively investigated and an even smaller proportion result in court action. The result is that those responsible for identifying and reporting about risks rarely find out whether their judgments were supported (Fleming 2005). One of the critical challenges for establishing effective risk-based AML systems is to find ways to share information about outcomes between the regulators and the regulated.

These issues are neither new nor unique to the Australian situation. Two reviews of the AML/CTF regime in the UK have pointed to the need for more detailed exchange of information between law enforcement agencies, regulatory agencies and financial institutions (KPMG 2003; Fleming 2005). The benefits claimed for improved feedback and communication include more effective matching between the content of Suspicious Activity Reports (SARs) and law enforcement agency (LEA) information requirements, improvements in the quality of SARs and the general performance of reporting agencies. The potential problems arising from inadequate information sharing may be particularly acute in the Australian context where the new legislation will cover a large number of small and medium sized businesses that have little capacity to invest in the development of sophisticated risk assessment systems. The consequence may be that different institutions will operate fundamentally different risk assessment systems. This is a situation that is unlikely to generate consistent outcomes, or engender public confidence.

## CDD, Privacy and Related Issues

The accurate identification of customers based on reliable, independent source documents or information (customer due diligence or CDD) is one of the cornerstones of an effective AML strategy. The new legislation imposes more stringent CDD requirements, and requires that CDD be exercised in a much greater range of situations than previously. These more demanding CDD requirements are at odds with one of the fundamental principles of banking – the bank's duty to respect privacy and confidentiality in its dealings with customers. As a result, one of the most contentious aspects of the new AML legislation has

been the degree to which it requires reporting entities to infringe on customer privacy (Latimer 2004; Lampe 2006). The Senate Committee report on the exposure draft of the Bill devotes a whole chapter to discussion of the privacy issues raised before the Committee (Parliament of Australia 2006). Issues of particular concern included:

- that the Bill involved infringements of personal privacy for large numbers of persons that was not proportionate to the actual AML or CTF risk involved;
- that requiring businesses to make judgments about the AML risk associated with each customer might lead to discriminatory treatment of customers classified as 'higher risk';
- that financial and other agencies with reporting obligations might use customer information that had been compulsorily collected for purposes unrelated to AML (e.g., marketing or customer profiling); and
- That information provided to AUSTRAC may be given to 'designated agencies' for purposes that may be unrelated to AML.

The Committee concluded that 'lack of formal consultation with privacy, civil rights and consumer representative groups' may have resulted in 'some fundamental privacy, consumer and civil rights issues being overlooked' (Parliament of Australia 2006:75). It recommended that the Bill should be the subject of a Privacy Impact Assessment,[3] and should include a 'clear objective statement that is reflective of the intention to allow federal, state and territory agencies, including welfare and support agencies, to access and utilize AUSTRAC data for their own purposes – purposes which may not be related in any way to AML or CTF' (Parliament of Australia 2006:75).

Privacy issues may yet prove to be a significant barrier to the effectiveness of the new regulatory regime. In the US, the legal profession has been a focus of resistance to the extension of AML regulation, with client confidentiality and professional privilege, and costs of compliance for solo practitioners and small firms particular areas of concern (Reuter & Truman 2004). One immediate consequence of the new regulatory regime is that Australians will need to get used to satisfying stringent identity requirements when conducting a wide range of routine financial activities. It remains to be seen whether these will prompt any kind of reaction.

## A New Role for AUSTRAC

The new Act, together with its attendant rules and guidelines, is only one element of an AML reform package that also includes fundamental changes in the role and functions of AUSTRAC and a higher level of funding to support the new regulatory regime. Under the existing compliance regulatory model, AUSTRAC collects financial transaction reports information, and then stores, analyses and disseminates intelligence derived from this data to domestic law enforcement, the Australian Taxation Office, security and social welfare agencies and upon request, to international FIUs. AUSTRAC also has a regulatory and compliance monitoring role in relation to CDD, although the FATF/APG review noted that this seemed to be a low priority, with few compliance inspections actually being conducted.

One consequence of the new AML legislation is that AUSTRAC will need to move further in the direction of being a general regulatory body in which intelligence will only be one of a range of functions alongside regulatory direction, compliance monitoring and enforcement, and education. An important role for AUSTRAC is the development of the

3 This was carried out in September 2006.

AML/CTF Rules (that is, directions or requirements that are more detailed and 'operational' than the provisions in the Act). The new Act considerably enhances AUSTRAC's compliance monitoring role. There is an explicit direction to AUSTRAC that it is responsible for regulatory compliance by reporting entities and this is supported by a new penalty framework and enforcement provisions. The AML regime is to be extended to a range of small and medium sized businesses that have not previously been subject to regulation, and have little experience in the complexities of CDD, and limited capacity to design and implement AML programs. It seems likely that AUSTRAC will need to give much greater attention to industry education and the development of AML monitoring and reporting capabilities.

At the same time, it seems certain that the collection, analysis and dissemination of intelligence will remain the single most important function for AUSTRAC. The key challenge in regard to this function is to increase the rate at which intelligence translates into law enforcement action and outcomes. In the UK, a series of reviews of the Suspicious Activity Reporting System (SARs) found that AML intelligence is under-used by law enforcement agencies (KPMG 2003; Fleming 2005; Lander 2006). The result was a significant restructuring of UK AML regulatory arrangements, with FIU responsibility being transferred from the National Criminal Intelligence Service to the new Serious Organised Crime Agency with the intention of increasing the quality of AML intelligence and their successful exploitation by LEAs.

A low rate of successful exploitation of AML intelligence is also a feature of the Australian AML regime, and at least some of the problems identified in the UK reviews (inconsistent training, poor inter-agency feedback and communication, inadequate resourcing of LEA AML activity, and the absence of a central focus and governance) were also cited in the FATF/APG review. AUSTRAC will face a substantial challenge in processing the greatly increased volumes of data generated by the new Act, exacerbated by the lack of standardisation of this information arising from the 'risk-based approach'. In addition, AUSTRAC faces the problem that LEA responsibility in Australia is dispersed between a range of Federal and State and Territory agencies. The combination of variations in local policing practices and legislative codes, a lack of focus on money laundering except as a means to identify the predicate crimes, the limited resources available in smaller jurisdictions, and the tendency of money launderers to seek out and exploit weaknesses means that obtaining consistent AML performance is likely to be problematic to say the least.

The adoption of a risk-based approach to AML raises important issues for the relationship between AUSTRAC and the businesses that it regulates. We noted earlier that industry representatives have already challenged the extent to which the new legislation is genuinely risk-based – in the sense of giving regulated entities the responsibility for defining risks and responding to them on the basis of their own assessments. Nevertheless, the success of the new regulatory regime will require that regulated entities become pro-active agents in the AML system. A key element in the new regulatory regime is that reporting entities must develop and implement AML programs that will identify, mitigate and manage money laundering risks, either individually or in partnership with similar businesses. While AUSTRAC will provide a framework for these AML programs through the AML/CTF Rules, each reporting entity must determine the precise form of these rules, and be responsible for their effective implementation. At the same time, there are pressures on AUSTRAC to understand and respond to the pressures on businesses. The Act requires that AUSTRAC must 'have regard to various factors including competitive neutrality,

economic efficiency and privacy in performing its functions' (Parliament of Australia 2006:2).

Thus, in order for the new regulatory regime to work effectively, there will need to be regular communication between AUSTRAC and the businesses it regulates about how regulation should work, and what should be done in order to make the system work more effectively. Communication between regulators and the regulated is not a strong point of many AML regimes. While the situation in regards to information sharing is better in Australia than in the UK – Fleming notes that AUSTRAC has a 'strongly cooperative relationship with reporting entities' (Fleming 2005:57) – the increasing complexity of the relationship between the regulator and the regulated will place much greater demands on this in the future.

## Conclusion: Regulatory Effectiveness and the AML Research Agenda

The new AML regime will impose substantial costs on Australia's financial sector and these costs must inevitably be passed on to customers. It is therefore important that we understand whether this regime is effective in detecting and preventing money laundering. If there is one lesson to be learned from Australia's recent AML history it is that the effectiveness of the new regulatory regime cannot be taken for granted. Legislation specifying a regulatory system is essentially a statement of intention. Its effectiveness depends on whether the mechanisms prescribed by the legislation are appropriate to the true nature of the problem to be regulated, and on whether these mechanisms are implemented diligently and productively.

It is not hard to find examples of the regulation of financial crime where a substantial gap is evident between expectations and reality. Freiberg and Fox (2000) examined Australian legislation on the confiscation of criminal assets and found that the 'almost mythical power' accorded to the provisions of the *Proceeds of Crime Act* were ineffectual in practice. Few offences were the subject of court action, and the amounts confiscated were only marginally greater than the costs of enforcement. They concluded that, despite repeated regulatory reform over a period of two decades, there was no evidence that the legislative goal of preventing criminals from profiting from their crime had been achieved.

The new Australian AML legislation is part of an international reform process, and it is tempting to conclude that since many comparable countries have been through similar reform processes, Australia must be on the right track. However, this process of international reform takes place at the same time as a vigorous debate about whether AML regulation has any significant impact on the problem. It is undeniable that the implementation of the FATF regulatory regime around the world has removed or ameliorated some of the most egregious money laundering methods. Criminals no longer have unfettered access to international wire transfers, or offshore shell banks, and can no longer hide behind bank secrecy laws. However, it is questionable whether the FATF reforms have changed the criminological problem of money laundering in any fundamental way. Despite the massive investment of resources in AML regulation, only a tiny fraction of money laundering offences are detected, only a tiny fraction of suspicious transactions that are reported are investigated, of these only a tiny fraction result in a criminal conviction, and those convicted represent the least consequential offenders (Cuellar 2003; Lander 2006). Reuter and Truman (2004:187) estimate that money launderers in the US face a 5% chance of being caught in any year.

A basic problem with understanding how AML regulation works is that there is a paucity of enforcement assessments: that is, systematic evaluations of how the various elements of the AML regulatory regime contribute to the goals of prevention, detection and conviction. This is a world-wide problem. Even in the USA, where expenditure on AML is many times greater than in Australia, the lack of systematic enforcement assessments mean that 'it is difficult to judge the effectiveness of current money laundering investigations' (Reuter & Truman 2004:186). The main assessment model for AML regulation is the FATF 'mutual evaluation' process, but this is primarily concerned with regulatory compliance – the extent to which a country's regulatory regime complies with the 40 Recommendations – and only secondarily with regulatory effectiveness. To date, there has been little if any detailed study of the effectiveness of the FATF AML Recommendations undertaken and even less research has been undertaken regarding the Special Nine counter-terrorism financing Recommendations.

A key issue is how regulatory effectiveness should be measured. The main benchmark used in the FATF mutual evaluations is the number of criminals caught and convicted for money laundering offences. However, even a superficial consideration of money laundering shows that crime or conviction rates are unlikely to provide useful measures of effectiveness. Money laundering is not a distinct offence comparable with more conventional crimes like burglary or robbery. Rather, it is a set of methodologies for making money acquired through some form of predicate crime available for other purposes. AML regulation may be effective if it deters offenders from committing these predicate crimes or imposes significant costs on these crimes or increases the likelihood that they will be caught and convicted for these predicate offences. One measure of AML regulatory effectiveness may therefore be its effect on rates of predicate crimes and the outcomes of law enforcement processes for these crimes.

One possible effect of regulation may be that it forces criminals to use methods that expose them to other risks of detection or conviction: for example, cash smuggling instead of integrating funds into the cash-flows of ostensibly legitimate businesses. So, other measures of regulatory effectiveness might be the detection rates of 'risky' versus 'non-risky' methods, or the extent to which criminals are able to gain control of businesses that can be used to launder funds. Increased regulatory scrutiny might force criminals to seek the services of professional launderers, although whether this should be seen as a desirable outcome is a moot point.

We began this article with an example that illustrates the ineffectiveness of the old AML regulatory regime. We can be confident that before long other criminals will seek to emulate Tony Mokbel, and it would be good to know that the new AML regulatory regime will be more effective than the old one.

## References

Attorney-General's Department (2004) Anti-Money Laundering Law Reform: Issues Paper 1, Financial Services Sector Canberra, Attorney-General's Department.

Australian Transaction Reports and Analysis Centre (AUSTRAC) (1995) Estimates of the Extent of Money Laundering In and Throughout Australia (Prepared by John Walker Consulting Services).

Australian Transaction Reports and Analysis Centre (AUSTRAC) (2005) AUSTRAC Annual Report 2004-2005 AUSTRAC, Canberra.

Bosworth-Davies, R (2006) 'Fraud and AML Too Potent a Mix', *Money Laundering Intelligence*, vol 9, no 1, p 6.

Cuellar, M-F (2003) 'The Tenuous Relationship Between the Fight Against Money Laundering and the Disruption of Criminal Finance', *Journal of Criminal Law and Criminology*, vol 93, no 2/3, pp 311-465.

Financial Action Task Force (FATF) (2004) The Forty Recommendations, Financial Action Task Force, Paris.

Financial Action Task Force (FATF) (2005) Third Mutual Evaluation Report on Anti-Money Laundering and Combatting the Financing of Terrorism: Australia, Financial Action Task Force, Paris.

Fleming, MH (2005) UK Law Enforcement Agency Use and Management of Suspicious Activity Reports: Towards Determining the Value of the Regime, Jill Dando Institute of Crime Science, University College, London.

Freiberg, A & Fox, R (2000) 'Evaluating the Effectiveness of Australia's Confiscation Laws', *The Australian and New Zealand Journal of Criminology*, vol 33, no 3, pp 239-265.

Haines, F (2003) 'Regulatory reform in the light of regulatory character: Assessing industrial safety change in aftermath of the Kader Toy Factory fire in Bangkok, Thailand', *Social and Legal Studies*, vol 12, no 4, pp 461-487.

He, P (2004) 'New Trends in Money Laundering – From the Real World to Cyberspace', *Journal of Money Laundering Control*, vol 8, no 1, pp 48-55.

Hutter, BM (2005) *The Attractions of Risk-based Regulation: accounting for the emergence of risk ideas in regulation*, Discussion Paper 33, Economic & Social Research Council Centre for Analysis of Risk and Regulation, London School of Economics and Political Science, London.

Johnson, DC (2002) 'How Offshore Havens Helped ENRON Escape Taxes', *New York Times*, New York.

KPMG (2003) 'Review of the Regime for Handling Suspicious Activity Reports', KPMG Forensic.

Lampe, A (2006) 'Privacy Tension', *Anti-Money Laundering*, November, p 48.

Lander, S (2006) 'Review of the Suspicious Activity Reports Scheme', Serious Organised Crime Agency.

Latimer, P (2004) 'Bank Secrecy in Australia: Terrorism Legislation as a New Exception to the *Tournier* Rule', *Journal of Money Laundering Control*, vol 8, no 1, pp 56-65.

McCusker, R (2005) 'Early fall-out of the Third Directive', *Money Laundering Intelligence*, no 2, pp 13-15.

Parliament of Australia (2005) Anti-Money Laundering and Counter Terrorism Financing Bill.

Parliament of Australia (2006) Anti-Money Laundering and Counter-Terrorism Financing Bill 2006 Replacement Explanatory Memorandum (Minister for Justice and Customs), House of Representatives, Parliament of the Commonwealth of Australia, Canberra.

Parliament of Australia (2006) Senate Legal and Constitutional Legislation Committee: Exposure Draft of the Anti-Money Laundering and Counter Terrorism Financing Bill 2005, Parliament of Australia, Canberra.

Phillipsohn, S (2001) 'The Dangers of New Technology – Laundering on the Internet', *Journal of Money Laundering Control*, vol 5, no 1, pp 87-95.

Pieth, M & Aiolfi, G (2003) *Anti-Money Laundering: Levelling the Playing Field*, Basel Institute of Governance, Basel, Switzerland.

Proctor, A (2005) 'Supporting a risk-based anti-money laundering approach through enforcement action', *Journal of Financial Regulation and Compliance*, vol 13, no 1, pp 10-14.

Reuter, P & Truman, EM (2004) *Chasing Dirty Money: The Fight Against Money Laundering*, Institute for International Economics, Washington DC.

Unger, B, Siegel, M, Ferwerder, J, de Kruijf, W, Busuioic, M , Wokke, K & Rawlings, G (2006) *The Amounts and Effects of Money Laundering: Report for the Ministry of Finance*, Utrecht School of Economics, Utrecht, Nederlands.

Walker, J (1999) 'How Big Is Global Money Laundering?', *Journal of Money Laundering Control*, vol 3, no 1.