

Background intelligence brief

Money laundering

July 2005

CRIME AND
MISCONDUCT
COMMISSION



QUEENSLAND

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Abbreviations

AUSTRAC	Australian Transaction Reports and Analysis Centre
CMC	Crime and Misconduct Commission
FATF	Financial Action Task Force (on money laundering)
FTRA	<i>Financial Transaction Reports Act 1988</i>
NPO	non-profit organisation
PEPs	politically exposed persons

Money laundering

Introduction

This background brief has been prepared by the Strategic Intelligence Unit of the Crime and Misconduct Commission (CMC) to provide CMC officers with a basic understanding of what money laundering is, and introduce some of the common terminology associated with the subject. The typical process of money laundering is described, and some examples of money laundering techniques are discussed.

Definition of money laundering

The term 'money laundering' refers to the activities and financial transactions that are undertaken with the specific aim of hiding the true source of income. Usually the money involved has been derived from an illegal enterprise and the goal is to give that money the appearance of coming from a legitimate source. Sometimes, however, money legitimately obtained can also become the subject of money laundering; it may, for example, be disposed of in such a way that it evades lawful taxation.

History

The term is said to originate from Mafia ownership of laundromats in the United States. Gangsters there were earning huge sums in cash from extortion, prostitution, gambling and bootleg liquor, and they needed to show a legitimate source for this income. One of the ways in which they were able to do this was by purchasing outwardly legitimate businesses and mixing their illicit earnings with the legitimate earnings they received from them. Laundromats were chosen by these gangsters because they were cash businesses. Laundromats also provide an apt analogy for the process of legitimising earnings: illegal (dirty) money is put through a cycle of transactions (washed), so that it comes out the other end as legal (clean) money (Steel 1998/2003).

Predicate offences

The predicate offences that usually require money laundering mechanisms to legalise otherwise illicit money can be grouped into five general classifications:

- drug trafficking
- other blue-collar crimes
- white-collar crimes
- bribery and corruption
- terrorism.

Research conducted by Reuter and Truman (2004) for their book *Chasing dirty money* led them to make some observations about the severity of the adverse effects of these crimes, and the people they predominantly affect. Their instruction to readers was to regard these

observations 'not as authoritative but simply to identify dimensions that deserve consideration in policy making and research'. Their views on the 'severity of harm' and 'the most affected population' are given below.

Drug trafficking

Major drug traffickers face the problem of managing large sums of cash, usually in small denominations, on a frequent basis. The harm to society caused by this form of crime is considered severe, and mainly affecting urban minority groups.

Other blue-collar crimes

Other blue-collar crimes include illegal gambling and bookmaking, people smuggling, and organ trafficking. The amounts of money involved in these operations are much smaller than those resulting from drug trafficking. This is probably because the amounts gambled and the total revenues are usually less, and because the money to be laundered consists of the net profits rather than the gross revenues. The harm to society associated with this form of crime is rated as low to moderate, and the most affected population is unknown.

White-collar crimes

The white-collar crime category includes embezzlement, fraud and tax evasion. A distinctive feature of these crimes is that money laundering is an integral part of the offence itself. For example, an offshore shelf company in a tax haven country may serve not only as a tax shelter but also as a laundering mechanism, using false invoicing and other accounting frauds, to obscure the trail of fraudulent activity. The harm to society caused by this form of crime is considered low, but the effect is spread broadly across the population.

Bribery and corruption

Because of their unique features, bribery and corruption are separately categorised rather than being included in white-collar crimes. The beneficiaries are usually public officials and those who stand to benefit from their decisions; and the bribery and corruption usually, but not always, takes place in poor countries and has the effect of reducing government credibility and the quality of public services. The money laundering aspects usually have international implications, as the funds are typically kept outside the local banking institutions. The public officials are known as 'politically exposed persons' (PEPs) — individuals who are, or have in the past been, entrusted with prominent public functions in a particular country. They include heads of state or government; senior politicians and government, judicial or military officials; senior executives of state-owned corporations; and important officials of political parties. PEPS who come from countries or regions where corruption is endemic seem to present the most potential risk, but corrupt or dishonest PEPs can be found in any country (FATF 2004). Many countries require financial institutions to apply particular diligence in their dealings with these types of customers, scrutinising the activity

on their accounts carefully and regularly. The harm to society associated with this form of crime is considered severe, with those most affected being the populations of developing countries.

Terrorism

Terrorism puts both legitimate and criminally derived funds to criminal use. The sums of money involved are believed to be modest; but, as the September 11 events of 2001 showed, the harm is unique and enormous, affecting a broad section of the population.

Overview

Money laundering plays a fundamental role in the activities of the drug trafficker, the organised criminal, the insider dealer, the tax evader, the terrorist, and the many others who need to avoid the kind of attention from the authorities that sudden wealth from illegal activities brings. By 'laundering' the proceeds, criminals hope to place them beyond the reach of any asset forfeiture laws.

The money laundering process

'Placement', 'layering' and 'integration' are terms used by law enforcement to describe the stages through which criminal proceeds are laundered (Molander, Mussington and Wilson 1998). They can occur either at the same time (in the course of a single transaction) or in separate transactions. While the three stages are not always present in each money laundering action, they are a useful way of analysing the process of legitimisation.

Placement is the first stage in the money laundering process, when the physical currency enters the financial system. It is during this phase that the illicit money is most vulnerable to detection. Placement may be accomplished by breaking up large amounts of cash into less conspicuous, smaller sums, which are then banked. They are either deposited directly into bank accounts, or a series of monetary instruments (cheques, bank drafts, money orders etc.) are purchased and then deposited into bank accounts at other locations. It is widely acknowledged that money laundering is best fought at the placement stage of the process, by instituting various checks and disclosure requirements to make it as difficult as possible for criminally tainted money to enter the financial system. In Australia, the *Financial Transaction Reports Act 1988* (FTRA) makes it mandatory to report certain types of financial transactions which involve cash and/or certain monetary instruments. Accordingly, money launderers need either to circumvent the legitimate financial system entirely, or violate (evade, manipulate or ignore) the regulatory requirements of the FTRA to conceal their activities.

Layering describes the activity undertaken by the launderer to distance the funds from their illicit source. This is achieved by a series of complex conversions or movements of the funds, which prevent any audit trail being left by the 'dirty' money as it is being laundered, and thus conceal the source and ownership of the funds. For example, the funds might be

channelled through the purchase and sales of investment instruments, or the launderer might simply wire the funds through a series of accounts at various banks across the globe. The use of tax havens, bank secrecy jurisdictions or countries that do not participate in measures to combat money laundering make it difficult for investigators to follow the money trail.

Integration is the final stage of the laundering process, when the funds re-enter the legitimate economy and the launderer makes the funds appear to have been legally earned. This may be accomplished by purchasing real estate, cars, precious metals, valuable jewellery or antiques. Alternatively, the funds may be used to invest in and operate legitimate business ventures. The integration of illicit monies into the legitimate economy is very difficult to detect if there is no audit trail established during the placement or layering stages (Shanmugam, Nair and Suganthi 2003).

Money laundering mechanisms

Money laundering schemes are very diverse, varying in character and complexity, and limited only by the imagination of the launderer. They can involve reputable financial institutions unwittingly providing laundering services to their wealthy, seemingly respectable clients. They can also involve small, financial or non-financial businesses knowingly providing laundering services — for example, a proprietor of a Bureau de Change exchanging large quantities of low-denomination local notes for high-denomination foreign currency, or a trucking business transporting cash across borders/countries for drug traffickers. Money laundering may be confined to the local financial community, but often it involves international transactions.

The examples below provide a brief insight into some of the mechanisms employed by launderers. These may play their part in only one phase of the money laundering process, or in all stages. The list is by no means exhaustive.

Cash smuggling

Cash is moved in bulk across states and countries by hiding it in cargo (e.g. hidden in luggage, TV sets or deodorant cans).

Structuring

Cash deposits are broken down into smaller sums that are below the FTRA reportable limit of \$10 000.

Smurfing

Couriers ('smurfs') are used to make deposits at a number of banks or to purchase bank cheques.

Casinos

Chips are bought with cash. Then, after a period of time during which gambling may or may not take place, the chips are cashed in for a cheque from the casino, possibly in the name of a third party. Alternatively, tokens may themselves be used as tender for purchasing goods, services or drugs.

Horseracing

Winning tickets are bought at a premium, providing an incentive for the winner to sell their ticket and enabling the launderer to collect a cheque from the racing authority.

Lotteries

The mechanism is similar to that for horseracing.

Insurance

The insurance sector is vulnerable to laundering because of the sheer size of the industry, the easy availability and diversity of its products, and the structure of its business. They are often cross-border businesses, and usually involve the distribution of their products through brokers or other intermediaries who are not necessarily under the control of the company issuing the product. Additionally, the beneficiary of the policy is often different from the policy holder. There are a number of ways in which insurance can be used in laundering:

- A high-premium policy can be purchased for a phantom asset with the illicit funds. Claims are made against the policy, for which cheques are received from the insurer.
- A single-premium insurance policy is purchased, with the entire premium paid upfront (rather than as annual premiums), and the policy is redeemed at a later date. The launderer receives a cheque from the insurance company for the unused portion of the policy less any fees and penalties.
- Several overpayments of the insurance policy premiums are made, after which a request is made to have the overpayments refunded by cheque to a third party.

Informal value transfer systems

These include 'hawalas' (an Arabic word meaning 'change' or 'transform'), 'hundi' (the Hindi equivalent, meaning 'trust') and 'fei ch'ien' (meaning flying money — indigenous to China). These systems allow money to be transferred around the globe without actual money movement or wire transfer. It provides anonymous services, operating out of nondescript little shops and bazaars. Cash is handed to a *hawaladar* in country A and the money is paid out by a *hawaladar* in country B.

Wire and electronic funds transfers

Funds are transferred through several different banks in numerous jurisdictions to conceal the source of the funds.

Legitimate business ownership

Illicit earnings are added to the cash revenues of a legitimate business enterprise — particularly one that predominantly deals in cash, such as a restaurant, bar or night club.

Shell corporations

These businesses exist on paper but transact little or no business. Shell corporations have many potential uses, such as use of its bank accounts in the layering process, facilitating fraudulent invoicing, and purchase and resale of assets during the integration phase.

Real estate transactions

Properties may be bought and sold under false names or by shell corporations, and can serve as collateral in other layering transactions. Real estate agencies can also serve as a legitimate front business (see 'Legitimate business ownership' above).

Purchase of high-value assets

These assets include gold, diamonds, precious metals, fine art and antiques. These assets are easy to move internationally and can be resold at market value to integrate the funds. In addition, false certificates of sale are easily produced and phoney reproductions created for sale.

Currency exchange bureaus

Bulky, low-denomination local currency may be converted to less bulky, high-denomination foreign currency, which is then physically smuggled out or wire-transferred to another country.

Stored value cards

Pre-paid money is stored on a card and can then be spent by the holder at various retailers.

e-money

This is money represented digitally by an issuing institution through a private encryption key. This can be exchanged electronically, by means of a smart card, from one party to another for goods and services anywhere in the world, without the need for an intermediary. One of its potential key features is its anonymity.

Lawyers

The use of client accounts is one of the most important services that lawyers can provide to those who seek to launder dirty money. It is easier for a criminal to introduce funds into the banking system through an intermediary such as a lawyer. Lawyers may receive cash deposits on account, issue or cash cheques, assist with the purchase or sale of stock, and send or receive international funds transfers. Lawyers may also provide advice on how to avoid leaving a money trail that can be followed, or how to avoid raising suspicions in the institutions through which funds pass.

Accountants, and financial and tax advisers

These professionals may use their expertise (on banking procedures, sophisticated international financial instruments, investments, company structures, trusts etc.) to advise criminals how to launder their money; or the professional advisers may arrange paperwork and conduct illicit transactions themselves.

Non-profit organisations (NPOs)

NPOs possess many characteristics that make them vulnerable to misuse for terrorist financing; for example, they enjoy the public trust, have access to considerable sources of funds, and are often cash-intensive. Some NPOs have a global presence that allows national and international operations and financial transactions. They are often subject to little or no regulation, and there are few barriers to their creation. NPOs can be used to collect funds, move funds or even serve as a cover for terrorist operations.

Harm caused by money laundering

There are many reasons why money laundering is harmful in society. Some examples are listed below.

- **It makes crime pay.** Money laundering allows drug traffickers, smugglers and other criminals to accumulate economic power and expand their operations. This has the potential to erode the political and social systems of a country, and could affect stability and the general rule of law (Alweendo 2005). This in turn drives up the cost of law enforcement and the spin-off costs of health care in the treatment of problems such as drug addiction.
- It has the potential to **undermine the financial community** because of the sheer magnitude of the sums involved. Money laundering on a grand scale has the potential to change the demand for cash, make interest rates and exchange rates more volatile, and cause high inflation rates for a country.
- Laundering **diminishes economic development** because it undermines legitimate business, competition and government tax revenue, and therefore indirectly harms honest taxpayers and reduces legitimate job opportunities.

- Perceived ease of entry to a country **attracts an undesirable element** across its borders, degrading quality of life and raising concerns about national security (Solicitor General Canada 1998). The crimes perpetrated by these undesirable elements erode basic individual liberties by threatening rights to life and entitlements to own property.

There are great incentives, therefore, for governments and private enterprise to work together to combat money laundering locally and globally.

Conclusion

In 1989 the G7 group of nations (US, Japan, Germany, UK, France, Italy and Canada) established the Financial Action Task Force (FATF), of which Australia is a member, to examine measures to combat money laundering, particularly the laundering of profits from the sale of illegal drugs (see website <www1.oecd.org/fatf>).

In 1990, the FATF, primarily involved in developing and promoting policies against money laundering at national and international levels, established 40 recommendations as an initiative to combat the misuse of financial systems by people laundering drug money. These recommendations have been reviewed twice since release, in 1996 and 2003, to take account of changing money laundering trends and terrorist financing. In direct response to the September 11 act of terrorism in 2001, the FATF issued the eight special recommendations; these constituted a basic framework to detect, prevent and suppress the financing of terrorism and acts of terrorism. The FATF Forty Recommendations 2003 and the FATF Eight Special Recommendations on Terrorist Financing 2001 are referred to jointly as the FATF Recommendations.

The FATF Recommendations cover:

- all the measures that national systems should implement within their criminal justice and regulatory systems
- the preventive measures to be taken by financial institutions and certain other businesses and professions
- measures for international cooperation.

These recommendations have been endorsed by more than 130 countries and are the international anti-money laundering standard. The FATF also monitors members' progress in implementing the recommended measures, as well as reviewing money laundering and terrorist financing techniques and countermeasures.

The Australian Government has had appropriate law enforcement structures and legislation to deal with money laundering for a number of years. The relevant legislation at Commonwealth level consists of:

- *Mutual Assistance in Criminal Matters Act 1987*
- *Financial Transaction Reports Act 1988 (FTRA)*
- *Proceeds of Crime Act 2002*.

The Australian Transaction Reports and Analysis Centre (AUSTRAC) was created to administer the FTRA. It receives reports of significant and suspicious transactions from cash dealers, and analyses these financial transaction data. Since enactment of the FTRA the definition of 'cash dealer' has been widened to include solicitors and people who carry on the business of currency exchange or remitting currency.

As part of its commitment to implementing the FATF Recommendations, the Attorney-General's Department is facilitating a major review of Australia's legislation against money laundering, and including some new measures designed to counter terrorist financing (see website <www.ag.gov.au>). It is intended that Australian Government agencies 'will consult and work with industry to design a cost-effective anti-money laundering system that will meet international standards and at the same time be responsive to the needs of Australian industry'. A series of industry-specific issues papers were released progressively from January 2004 to serve as a basis for discussion:

- Issues Paper 1, *Financial services sector*
- Issues Paper 2, *Real estate dealers*
- Issues Paper 3, *Dealers in precious metals and stones*
- Issues Paper 4, *Gambling industry*
- Issues Paper 5, *Legal practitioners, accountants, company and trust services providers.*

There are also various mechanisms at state level to combat crime and its resultant money flows. In Queensland the relevant Acts are:

- *Criminal Code Act 1899*
- *Criminal Proceeds Confiscation Act 2002.*

It is encouraging that, increasingly, private enterprise has come together to combat money laundering. Private companies realise that the scandals created by such activity not only cost the banks money, but also create negative publicity and invite closer regulatory scrutiny of their activities. Eleven international banks signed a set of principles known as the Wolfsberg Anti-Money Laundering Principles (the Wolfsberg Principles) in October 2000. The Wolfsberg Principles are a non-binding set of best-practice guidelines governing the establishment and maintenance of relationships between private bankers and clients. The main purpose of the Wolfsberg Principles is to ensure that the services offered by the banks and their worldwide operations are not abused for criminal purposes. Primarily, this is accomplished by '... accepting only those clients whose source of wealth and funds can be reasonably established as legitimate' (Hinterseer 2001).

These various mechanisms to combat money laundering should cause more financial assets and financial transactions to fall under the scrutiny of the regulated financial sector. Criminal elements who want to remain out of the regulated sector should find that the section of the global network in which they can easily operate unnoticed is shrinking, and moving money to the regulated sector is getting more difficult.

Increased cooperation between governments, financial institutions and law enforcement agencies is the way forward. Money will continue to be laundered, and a combined, multifaceted approach is the only solution.

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