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How Banks Assist Capital Flight from Africa: A Literature Review

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Preface

Systematic studies of the banking sector's involvement in facilitating capital flight from developing countries are limited. This report was commissioned by Norad's Anti-Corruption Project (ANKOR) for the purpose of summarising key lessons from the existing literature and to identifying knowledge gaps. The study focuses on capital flight from Africa and how much needed public finances are hidden abroad. It is a desk study, based on a review of library and online literature databases and reports and documentation from national and international organisations.

The material reviewed does not provide the information necessary to draw firm conclusions as to what constitutes 'best practice' in providing donor support for better regulation of banks and financial institutions in Africa. The term 'best practice' itself is unclear and depends much on the environment within which finance institutions work. The review shows that banks should not be disregarded as passive players when analysing capital flight. Banks play an active role in facilitating capital flight from Africa. However, to improve the regulation of the banking and finance sectors, there is a need for more detailed knowledge on how banks actually operate as facilitators and the mechanisms applied.

The paper is prepared by Kari Heggstad and Odd-Helge Fjeldstad from Chr. Michelsen Institute (CMI), Bergen, Norway. Fridtjov Thorkildsen, Director of ANKOR, gave useful suggestions for the structure of the study and Lise Stensrud followed up during the writing process. Valuable comments on earlier drafts were received from Fredrik Eriksson and Alessandra Fontana. The librarians at Chr. Michelsen Institute have provided important support, and we are grateful for their always positive and effective handling of our frequent and often demanding requests for relevant literature. The responsibility for any errors or shortcomings rests entirely on the authors.

Executive summary

This paper provides an overview of existing literature on the role of banks in capital flight from Africa. The review demonstrates that banks should not be disregarded as passive players when analysing capital flight. Banks play an active role in facilitating capital flight. However, to improve the regulation of the banking and finance sectors, there is a need for more detailed knowledge on how banks actually operate as facilitators and the mechanisms applied.

The study addresses the following questions:

- What literature exists on the role of banks in capital flight from Africa?
- What are the main focus areas of the available literature?
- What are the most common methods for banks to channel illicit financial flows?
- Which institutions and actors are currently addressing the issues?
- Which knowledge gaps can be identified through the literature review?

Our general conclusion is that more knowledge is needed on how banks assist political elites and their close associates, companies, individuals and organised crime to channel capital out of African countries.

Relevant literature where the banking sector features can be divided into four thematic areas:

(i) Money laundering

The status of regulations for anti-money laundering varies to a large extent between African countries. The literature shows that there is a huge challenge for banks to avoid tainted funds from politically exposed persons (PEPs). Investigations have found that financial institutions have been aggressively marketing methods of hiding money from national tax authorities in secrecy jurisdictions. Channelling funds to terrorist activities has taken place via formal finance institutions. However, informal financial networks are commonly also involved.

(ii) Secrecy jurisdictions and calls for transparency

Banks in secrecy jurisdictions play an important role in facilitating the hiding and laundering of capital from Africa because of the secrecy space that exists for financial activities and banking (Kapoor, 2007; Murphy, 2008). The legal part of banking activities in secrecy jurisdictions is argued to be largely overlooked in much of the literature criticising these types of financial structures.

(iii) Customer due diligence and banking in developing countries

For anti money laundering and prevention of terrorist financing strict 'know your customer' (KYC) routines are essential. The rules and practices for due diligence vary substantially between jurisdictions and between banks. Assessments by the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG) show that although commitment to follow customer due diligence principles are increasing world wide, many countries are largely non-compliant. There are huge variations between African countries with respect to the level of regulations and their implementation (ESAAMLG 2009a).

The incentives of banks to do due diligence checks on their customers are debated in the literature. The main difference is between those who argue that the benefits are too large for private banks to resist the temptation to facilitate banking for PEPs and wealthy individuals regardless of the origin of the funds, and those who consider the risk to be too high for banks if due diligence rules are not followed.

(IV) Asset recovery

Effective strategies and laws to trace illicit financial flows are still inadequate in sub-Saharan Africa, and the major obstacles to the recovery of stolen assets are said to be the lack of capacity in developing countries to negotiate the complex legal issues together with the lack of will from some developed countries to assist in the repatriation process (Chaikin and Sharman, 2009; Goredema 2009).

Capital flight - with a little help from the banks

“The management of the payment system places banks in a crucial position with respect to the money laundering activity” (Masciandro, 2007:29). Typically banks in secrecy jurisdictions are used in the process. The level of sophistication varies, and the most complex schemes include multiple jurisdictions and a large number of bank accounts in an array of banks. In many high-level cases the money is moved through a maze of shell companies and respectable nominees. Collusion with bank employees at all levels is often found.

Still, banks are often involved in only parts of the money laundering chain and the placement of illicitly gained cash. Thus, improved regulation of the banking sector will only contribute to solve a part of the problem.

Relevant organisations

An increasing number of organisations are addressing the challenges of illicit financial flows. These include global NGOs, think tanks, research institutes and financial intelligence units. Recently, several development agencies, including multilateral finance institutions and bilateral donors, have placed capital flight and asset recovery on their agenda. An overview of key organisations and initiatives are presented in Chapter 5.

Policy relevance

The specific country setting should be considered when development agencies address capital flight challenges. The high levels of corruption that often is linked to capital flight from Africa are likely to put severe constraints on the implementation of reforms.

a) Recommendations for banking institutions:

- Create clear control mechanisms, policies and procedures
- Conduct regular training of staff in due diligence and ‘know your customer’ (KYC) principles
- Establish comprehensive KYC routines
- Streamline reporting routines from bank staff to relevant authorities
- Place the main responsibility at the management level

b) Recommendations for governments and development agencies:

- The cross-ministerial issue of illicit financial flows will need a cross-ministerial approach for donor engagement and government efforts
- When required, development agencies should provide resources for professional guidance and capacity building in asset recovery cases.
- UNCAC and FATF may be easier to follow in practice if governments agree on an effective review mechanism.
- FATF member governments could use their position within FATF to make fighting corruption a priority and to ensure that FATF members comply with the standards.
- Banks, governments and development agencies can allocate resources to capacity building and training of bank personnel in due diligence and in accordance with KYC principles.
- Identification of bank customers will be more secure with nationally approved and standardised identification papers. Donor agencies could potentially assist government effort to develop the system if requested.
- Governments should establish legislation that makes aggressive marketing of banking in tax havens within the boundaries of their country more difficult.

c) Recommendations for international organisations:

- FATF should assess whether their recommendations are sufficiently addressing the particular context of African economies.
- NGOs and the media may play an important role in informing civil society of corrupt actions of PEPs by publishing knowledge that is easily available and accessible for the public.

Further research

Much of the current debate focuses on financial centres in secrecy jurisdictions. It is, however, also important to gain better knowledge and understanding of the whole chain of official and unofficial finance institutions, and the linkages between these.

1 Introduction

Banks and financial institutions are an important piece of the puzzle when illicit financial flows leave developing countries. Thus, the supply side of services facilitating illicit financial flows has recently received more attention by donors and policymakers (e.g. NOU 2009). Still, systematic studies of the banking sector's involvement in facilitating capital flight from developing countries are limited. This note provides an overview of existing literature. It focuses on capital flight from Africa and how dearly needed public finances are hidden abroad. The review shows that banks should not be disregarded as passive players when analysing capital flight. Banks play an active role in facilitating capital flight from Africa. However, to improve the regulation of the banking and finance sectors, there is a need for more detailed knowledge on how banks actually operate as facilitators and the mechanisms applied.

The study addresses the following questions:

- What literature exists on the role of banks in capital flight from Africa?
- What are the main focus areas of the available literature?
- What are the most common methods for banks to channel illicit financial flows?
- Which institutions and actors are currently addressing the issues?
- Which knowledge gaps can be identified through the literature review?

The study includes research of library and online literature databases and material compiled from national and international organisations.

More knowledge is needed

Our general conclusion is that more knowledge is needed on how banks assist politicians and their close associates, individuals, businesses and organised crime organisations to channel capital out of Africa. The existing literature on capital flight addresses parts of the challenges with respect to illicit financial flows from African countries, including developmental impacts and the role of offshore financial centres. The role of onshore banks, however, is generally not examined. Further, literature on the banking sector in Africa rarely refers to capital flight. Thus, a challenge for this review has been to identify literature where capital flight and banks are analysed together in an African context. The review maps and assesses the most relevant available documentation, and gives an introduction to the questions raised above. Further, it identifies some knowledge gaps for further research. This review may therefore serve as an initial first step for the development of more in-depth knowledge on how banks facilitate capital flight from Africa.

The report is structured as follows: The following chapter 2 clarifies how capital flight and banking are defined in this review. Chapter 3 presents the main discussions addressed in the current literature. An overview of the most common methods applied for channelling illicit financial flows through banks is included in chapter 4. It explains how banks operate when transferring with suspicious funds on behalf of their clients. Chapter 5 provides an overview of organisations and institutions currently working on issues related to banking regulations and capital flight. The map of involved actors may serve as a guide to practitioners and researchers who want to explore the issues further. Chapter 6 presents policy recommendations based on the reviewed literature. Finally, chapter 7 concludes by suggesting issues for further research.

2 Defining capital flight and banking

The term **capital flight** does not have one universally accepted and precise definition. Actors who aim to reduce or stop capital flight from developing countries thus have a challenge. What exactly are they addressing? In this review we will follow the definition by Kapoor (2007:6-7) of capital flight as “**unrecorded and (mostly) untaxed illicit leakage of capital and resources out of country**”. His understanding opens up for an analysis of how capital flight potentially impacts on development. The characteristics of capital flight according to the above definition are that the resources are domestic wealth that is permanently put out of reach for domestic authorities. Much of the value is unrecorded and attempts to hide the origin, destination and true ownership of the capital are parts of the concept.

Many authors use the term ‘capital flight’ to describe processes beyond what is described above. Examples of other angles are to view capital flight as (a) sudden short-term capital outflows, including both licit and illicit flows, or (b) the stock of wealth, both licitly and illicitly acquired, held abroad by the citizens of a developing country (Epstein, 2005:58-65). In this report we will not take into account the licit financial flows from developing countries. We will, however, apply a sufficiently wide definition to include most channels of illicit flows from poor countries (Kapoor, 2007:6-9). The concepts ‘illicit financial flows’ and ‘capital flight’ will be used interchangeably, although according to some definitions capital flight also contains the licit stream of money leaving the country.

The distinction between what should be defined as illicit and what can pass for licit flows are not always clear. On the one hand a lawyer will categorise what is not illegal as legal. A lawyer can thus perceive the grey zones as their area of creating a business, because they are in a special position to advise clients on how to use the loopholes and grey zones for the best interest of the client. On the other hand, grey zones can be perceived as potentially dodgy, because there is space for immoral behaviour that does not necessarily care for the original intention of the laws.

Example of capital flight: public loans are turned into private assets

Foreign debt and capital flight are found to be closely interlinked. Research by economists and political scientists suggests that a large extent of the capital flight from Africa has been public loans that were channelled out of the country as private funds. The ‘know your customer’ principle of banks has not managed to stop politically exposed persons (PEPs) from stealing public funds and to storing the stolen assets in private accounts abroad. A ‘revolving door’ relationship has been identified between debt and capital flight. In some cases as much as 80 percent of the public loans have left the country as private assets through capital flight (Ajayi and Khan, 2000; Boyce and Ndikumana, 2001; Cerra et al., 2008; Ndikumana and Boyce, 2003; Ndikumana and Boyce, 1998; Ndikumana and Boyce, 2008).

Banks are in this report referred to as financial institutions that are licensed by the government. The financial services offered may vary from country to country, but managing bank accounts are seen as one of the most indispensable services of a bank. There are several methods of transferring values that do not involve a bank transfer. However, non-banks that provide payment services such as remittance companies offer a narrow set of services and are therefore rarely considered to be a proficient substitute for banks. Banks and other financial service providers are rather seen to complement each other. Thus, flows of money channelled through various institutions are expected to end up in the banking system at some point. Therefore, it is important to focus specifically on the role of banks in facilitating capital flight. Masciandro (2007:27), however, claims that the development of the architecture of markets and the characteristics of intermediaries have blurred the

difference between banking and non-banking firms. Hence, we will include some observations on financial services provided by other institutions in order to show how banks fit into a wider global financial structure.

The jurisdiction which the bank operates within lays out conditions for what kind of services a bank can offer.¹ Varying levels of customer confidentiality are the most important difference between banks which are pointed out in the literature. **Offshore banks, secrecy jurisdictions and tax havens** are the most commonly used concepts to describe the extraordinary confidentiality conditions that are found within certain jurisdictions, such as Mauritius and Cayman Island. A commonly accepted definition is not in place to describe and categorise jurisdictions with different financial services combined with secrecy rules and tax benefits. Therefore, no conclusive list exists of countries with a banking sector that are specifically attractive for transfers of illicit capital.

‘Secrecy jurisdiction’ is the term most frequently used in this report since it points to the legal space which the banks operate within. This term has a better explanatory value to the phenomenon of regulatory vacuums created by secrecy jurisdictions than alternative expressions.² A secrecy jurisdiction has two main characteristics: a) part of its financial regulations is primarily designed to benefit non-residents of its territorial domain; and b) regulations exist that prevent the identification of those who use its regulations and are residents outside the jurisdiction (Murphy 2008). The **secrecy space** that is formed by these jurisdictions can be referred to as the unregulated spaces or regulatory vacuums for economic transactions that are created by the services offered. Banks, lawyers, accountants, trust companies, and others who assist customers to access the services offered by secrecy jurisdictions are examples of **secrecy providers**. **Secrecy world** can be used to describe the combination of the secrecy jurisdiction, - space and – providers (ibid.: 28). For the case of simplicity, secrecy jurisdiction refers in this paper to both the geographical location and the conceptual secrecy space.

¹ A jurisdiction refers to the geographical area within which authority and powers have been granted to the executive and legislative branches. This may be a state, dependency, protectorate, sub-national state, principality or other that has the ability to create law.

² Alternative concepts to describe secrecy jurisdictions are offshore banking and tax havens. These two descriptions are by some accused of being imprecise. The term ‘offshore’ may give an incorrect impression about a specific geographical location offshore. The Financial Secrecy Index shows that many of the least transparent places are onshore in the UK and the US (TJN and Christian Aid 2009). Further, the secrecy space that is created due to lack of transparency can be regarded as a non-geographical space. Thus, ‘offshore’ can be a misleading concept. The term ‘tax haven’ may give an impression that tax avoidance is the only purpose, while research show that other financial services are equally important. Murphy (2008) and NOU (2009) provide good overviews of the discussion on definitions and concepts.

3 What is on the agenda?

Relevant literature where the banking sector features can be divided into four thematic areas:

- (i) Money laundering
- (ii) Secrecy jurisdictions and calls for transparency
- (iii) Customer due diligence and banking in developing countries
- (iv) Asset recovery

Each of these categories is discussed below, drawing on existing literature within the field.

(i) Money laundering

Money laundering requires three major steps. First is the placement where the money is entering the legitimate financial system. Second is the layering where the money is moved through the international financial system. Third, the money is integrated into the legitimate economy when its origin is disguised (UNODC, 1998; Chêne, 2009). Banks could potentially be involved in all three steps in various ways, but not necessarily in such a way that bank personnel would be able to trace the origin of the money or the actual owner.

Charles Goredema from the Institute for Security Studies (ISS), Cape Town, has published two monographs which provide overviews of the capacity to tackling money laundering in East and Southern Africa (Goredema 2004a, 2004b). Recent updates on the region are found in some IMF country reports, including **‘Mauritius: Report on the Observance of Standards and Codes—FATF Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism’** (IMF, 2008), and reports from the Eastern and Southern Money Laundering Group (ESAAMLG, 2009a, 2009b; FATF and ESAAMLG, 2009; Goredema and Madzima, 2009). The status of regulations for anti-money laundering in various African countries varies to a large extent, and policy making must thus focus on the country level to be efficient. Moshi (2007) underlines that there are some structures that are unique and common for African countries. He argues that these have to be accounted for in anti-money laundering and combating the financing of terrorism (AML/CFT) measures. Moshi (2007) criticises the global initiative of FATF³ and other financial standards for not giving practical and realistic methods of how to prevent and detect money laundering and terrorist financing in the African context. According to Moshi (2007:7), the standards do not sufficiently recognise that African economies are (a) largely cash based, (b) there is a heavy reliance on a parallel, informal banking system, and (c) informal value transfer methods are the norm. Others, such as Christensen (2009:7), argue against those claiming that money laundering is a structural problem and blame instead lack of political will.

Tax evasion, terrorist financing and corruption

The literature on money laundering is often divided thematically into tax evasion, terrorist financing and corruption. Examples are OECD’s initiative on tax crimes and money laundering (OECD, 2009); UN conventions and other international standards concerning anti-money laundering and countering the financing of terrorism (UNODC, 2007); and the book **‘Corruption and money laundering. A symbiotic relationship’** by Chaikin and Sharman (2009). Thus, there are overlaps

³ The Financial Action Task Force (FATF) is an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing that has made two sets of AML/CFT recommendations that are internationally acknowledged.

between the thematic areas because the expected money laundering techniques commonly coincide. Banks often play a facilitating role in money laundering, although we will expect that the behaviour of banks differ depending on the type of customer and the suspected origin of the funds. Investigations show that there is a large challenge for banks to avoid tainted funds from politically exposed persons (PEPs). Banks have been utilized to channel illicit funds acquired by politically powerful persons out of the country of residence and into hidden, private accounts (Palmer, 2009). Examples from Africa include former president Sani Abacha in Nigeria, President Teodoro Obiang in Equatorial Guinea and the late president Omar Bongo in Gabon (Daniel et al., 2008/09; US Senate Permanent Subcommittee on Investigations, 1999; Jimu, 2009; Pieth, 2008; Global Witness, 2009a).

With respect to tax evasion, the U.S. Permanent Subcommittee on Investigations found that financial institutions were aggressively marketing methods of hiding money from the national tax authorities into secrecy jurisdictions. For instance, bankers from the Swizz banking giant UBS travelled to the U.S. in search of wealthy individuals and proactively promoted their services to these. UBS has now stopped all staff travels to the U.S. (US Senate Permanent Subcommittee on Investigations, 2003, 2006, 2008). How widespread the 'UBS-practice' is and how targeted African countries have been is not known from the literature reviewed. But it is likely that the practise revealed in the U.S. has been common in other countries too, though - in the African context - probably more targeted towards a small political and economic elite.

Channelling funds to terrorist activities often take place via formal finance institutions. However, informal financial networks are commonly also involved. These are systems where formal rules and regulations are not guaranteed to be followed (Passas, 2003, 2006). Underground (hawala) banking are used for legal transfers between countries and other purposes than terrorist funding, but it is mainly in the literature on terrorist funding that the issue is raised. Due diligence practices and registers of transfers do not necessarily exist in informal banking (Baker, 2005; McCusker, 2005). Further research on the underground banking system is required to shed light on whether and how informal systems parallel or substitute the formal bank system.

(ii) Secrecy jurisdictions and calls for transparency

Banks in secrecy jurisdictions have been found to play an important role in facilitating the hiding or laundering of capital from Africa because of the secrecy space that exists for financial activities and banking (Kapoor, 2007; Murphy, 2008). It is argued that more transparency in the financial sector in these jurisdictions is required to give businesses, criminals and politically exposed persons (PEPs), such as high-level politicians and associates, fewer ways to hide their illegally gained capital. For developing countries more transparency and fewer hiding places could mean that less public funds would be channelled out of the country as private assets. Thus, it is argued that more resources would be available for service provision and poverty reduction measures (Christian Aid, 2008, Task Force on Financial Integrity and Economic Development, 2009a, 2009b).

Support for secrecy jurisdictions?

Although there is a wide literature promoting transparency and condemning the negative consequences of secrecy banking, the literature is not exclusively portraying secrecy jurisdictions negatively. There is general agreement of the need to countering money laundering and the financing of terrorism, but the views on how to do so differ. On the one side are those promoting transparency who argue in favour of country-by-country reporting and global agreements to end banking secrecy (Christensen, 2009; Christian Aid, 2008; NoU, 2009; Murphy, 2009). On the other side are trade organisations, business people and lawyers who argue that the picture portrayed of

secrecy jurisdictions is highly skewed, and that these jurisdictions are professional, well functioning finance centres with important functions for legitimate businesses. Examples of positive features are political and economic stability, standardisation of language, a tailored legal framework and that double taxation of international operations are easier to avoid. The legal part of banking activities in secrecy jurisdictions is argued to be largely overlooked in much of the literature criticising these types of financial structures. To close down banking operations in secrecy jurisdictions are therefore not a desired alternative for all (Antoine, 2002; NHO, 2009). In the volume **‘Capitalism’s Achilles heel. Dirty money and how to renew the free-market system’** Raymond Baker (2005) criticises the ideas supporting the secrecy structures as fundamentally flawed. He dismisses the possibility of being able to **“successfully protect ourselves from a narrow range of dirty money we think hurts us, while at the same time cultivating a much broader range of dirty money that we think help us”** (Baker, 2005:190). However, full transparency is not necessarily what is requested. OECD (2010:14) states that some banking secrecy must be accepted, but that it is the possibility of lifting the secrecy in well defined circumstances to enable countries to enforce their own laws that are required.

The end of secrecy?

As a consequence of the crisis that struck the global financial system in 2007/08, secrecy jurisdictions have come into public scrutiny for providing tools for tax evasion, money laundering and terrorist funding. In the report **‘The morning after the night before. The impact of the financial crisis on the developing world’** Christian Aid (2008) explains how lack of transparency in financial centres and banking secrecy contributed to create turmoil in the global financial market. Earlier publications also point to the damaging effects of banking secrecy, but the financial crisis has given a new urgency to the topic (G20, 2009; Global Witness et al., 2009). OECD (2010:2) describes the topic of tax evasion and secrecy jurisdictions as **‘very high on the political agenda’**.

The media have followed up the focus on secrecy jurisdictions. Newspaper articles such as the New York Times ‘A Swiss bank is set to open its secret files’ (Browning, 2009) report a change in the secrecy rules of some jurisdictions. Christian Aid (2008:12) goes as far as to claim that most of the shadow banking sector has disappeared after the financial crisis since banks are not willing to engage in activities to the levels of business and mortgage as before the crisis. Other authors, however, seem to advocate the opposite view. For instance, Christensen (2009) raises concern about Ghana’s plans of creating a new secrecy jurisdiction in Accra. Reuters (2009) reports that the “Swiss bank UBS (UBSN.VX) is threatening to move its headquarters out of Switzerland if the authorities impose too many new regulations in the wake of the global financial crisis”. In sum, although there have been some reported improvements in bank transparency the general picture is dubious.

Further research

More insight on how the financial crisis has impacted on banking behaviour towards secrecy and due diligence controls is required to provide relevant policy recommendations. There is also a need for more research on the consequences for various actors of changing the secrecy laws. How will the economy of the secrecy jurisdictions be affected? What will be the consequences for investments that cannot be channelled through secrecy jurisdictions anymore? An example of research that considers developmental consequences of secrecy jurisdictions are the Norwegian report **‘Tax havens and development’** (NOU, 2009;), which discusses whether the state owned investment fund for developing countries (Norfund) should channel its investments via secrecy jurisdictions. A relevant following up study would be to estimate economic consequences for selected developing countries if Norfund’s use of secrecy jurisdictions was banned. In this

perspective, it is worth mentioning that Sweden decided in 2009 to stop using secrecy jurisdictions to channel development aid (Development Today, 2009).

(iii) Customer due diligence and banking in African countries

The due diligence done by banks on their customers is called Know Your Customer (KYC), and the essential elements are listed in the box to the left. Due diligence done by banks are important to establish knowledge of who the true beneficiaries of the funds are and whether the funds are obtained through legal or illegal activities. For anti money laundering and prevention of terrorist financing strict KYC routines are essential.

The rules and practices for due diligence vary substantially between jurisdictions and between banks. FATF and the Basel Committee for Banking Supervision have created international recommendations for minimum standards. Individual jurisdictions and banks decide their own due diligence rules. The purpose of the guidelines is to inform banks and jurisdictions of the importance of due diligence and how due diligence can be implemented. The international recommendations can also be used as a benchmark to evaluate at what level jurisdictions and banks are committed to due diligence procedures (UNODC, 2007; BIS, 2001).

Due diligence by banks –essential elements:

1. Customer acceptance policy
2. Customer identification
3. On-going monitoring of high risk accounts
4. Risk management

The bank has to both check the identity of the true customer and routinely monitor the accounts (BIS, 2001: 5).

African realities versus recommended regulations

According to its own statements, the banking sector is committed to self-regulation and to the adaptation of customer due diligence standards from the Basel Committee on Banking Supervision (BCBS) and the Financial Action Task Force on Money Laundering (FATF)(BIS, 2001). However, the actual compliance to the principles has proved to be weak in many cases. Assessments by the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG) show that although commitment to follow customer due diligence principles are increasing world wide, many countries are largely non-compliant. There are huge variations between African countries with respect to the level of regulations and their implementation (ESAAMLG 2009a). For instance, in Uganda banks train their staff in ‘Know your customer’ principles. Yet, in practice the principle is almost impossible to follow since there are no officially recognised identification documents for Ugandan nationals. The lack of acknowledged identification documents opens up for fraud (ESAAMLG 2009b). In South Africa, on the other hand, the system is more developed. In 2007/08 the South African Financial Intelligence Centre received 24,585 suspicious transfer reports (STRs). Another issue, however, is what happens when a STR is filed and concern has been raised, and whether the South African judicial system has the capacity to process all the required cases (FIC South Africa, 2007-2008).

Further research on the relationship between Financial Intelligence Units, revenue authorities, customs departments and related institutions such as the judiciary is required to generate better

knowledge on where the weak and vulnerable links at the country level are for detecting and hindering fraud and money laundering. Since the systems differ between countries, country specific studies are important.

Why should banks know their customers?

The incentives of banks to do due diligence checks on their customers are debated in the literature. The main difference is between those who argue that the benefits are too large for private banks to resist the temptation to facilitate banking for PEPs and wealthy individuals regardless of the origin of the funds, and those who consider the risk to be too high for banks if due diligence rules are not followed. The main reasoning behind these diverging views is presented below.

Banks have incentives to assist wealthy customers with managing their wealth regardless of the origin of the funds, because the nature of the banking business makes large customers attractive (Palmer, 2009). Global Witness has documented that high ranking politicians have been helped by banks to transfer large amounts of public funds into secret or hidden private accounts (Global Witness, 1999; 2009a; 2009b). However, FATF, the Basel Committee on Banking Supervision and the Offshore Group of Banking Supervisors argue that banks put themselves in a high risk situation if KYC routines are not followed. Serious banks should therefore not engage in business transactions when the legitimate origin of the funds is unclear. The risks for banks if not following KYC regulations are reputational, operational, legal and on customer concentration (BIS, 2001).

Ways of complicating due diligence controls in banks:

- Trust, nominee and fiduciary accounts
- Corporate vehicles
- Introduced business
- Client accounts opened by professional intermediaries
- Politically exposed persons
- Non-face-to-face customers
- Correspondent banking

Source: (BIS 2001:13)

Reputational risk is serious for banks since their business requires that depositors, creditors and the general marketplace trust the bank to be professionally run. As Christian Aid (2008:8) points out “**It’s a world where reputation is all**”. If there is doubt about the qualifications, integrity and motivations of the bank, there is a risk that clients will leave. The same counts for the **operational risk** if there is doubt that internal processes are practiced efficiently. **Legal risks** open for costly lawsuits and unenforceable contracts that can affect the operations of the bank. If the bank does not do a proper due diligence check the **concentration risk** is unmanaged, and the bank risks to become too dependent of a few clients because the bank management does not have an overview of who and how many independent clients they have (BIS, 2001:3-5).

Although there is considerable risk connected to weak due diligence, several reports and newspaper articles document that banks nevertheless do assist politically exposed persons and powerful, wealthy figures. Global Witness placed the role of banks on the international agenda in 2009 with the report ‘*Undue Diligence. How banks do business with corrupt regimes*’ (Global Witness 2009a). The report received much attention (Palmer, 2009; The Economist, 2009a). In November

2009, Global Witness published a new study on how banks facilitate illicit flows from developing countries. The report, entitled *'The secret life of a shopaholic'*, documents, for instance, how the son of the president of Equatorial Guinea managed to use a network of Western banks to channel large amounts of public funds out of the country and into private accounts (Global Witness, 2009a; U.S. Department of Justice, 2007; Urbina, 2009). The Global Witness reports are naming politically exposed persons (PEPs), and they have a clear agenda to stop Western governments and banks from facilitating the looting of public funds from developing countries. The focus of these and similar studies is on Western banks and their lack of compliance to the 'Know Your Customer' principle (US Senate Permanent Subcommittee on Investigations, 1999; Greenberg et al., 2009; The Economist, 2009a, 2009b). The findings are interesting because they show that capital flight and money laundering may be facilitated by Western banks even though these banks often are perceived as more legitimate compared to offshore banks and poorly regulated banks in developing countries.

In the book **'Black finance. The economics of money laundering'** Masciandro (2007) distinguishes between categories of banks. Banks can not be separated into 'good' and 'bad' ones. Effective and honest banks may not be aware that funds might be illicit because the money launderer uses skilful methods to avoid scrutiny by bank staff. In honest, but ineffective banks the gaps between good intentions and actual compliance with the regulations can be taken advantage of. There are also dishonest banks that will facilitate illicit activities. Baker (2005:43) explains a method for creating one's own bank to laundering money and taking advantage of innocent depositors. Further, in the volume **'All is clouded by desire'** Block and Weaver (2004) show how the Geneva banker Bruce Rappaport and the Bank of New York worked together with dodgy Russian banks to move and launder USD 6 billion for Russian organized criminals and other shady organizations and individuals. In other words, the intention behind the bank activity will play a role for policy makers promoting the implementation of stricter KYC regulations. Honest banks, whether efficient or not, will presumably willingly comply while dishonest banks have to be addressed in a different way.

In sum, the literature offers a combination of regulations and handbooks on due diligence, critical investigative reports from NGOs and investigative units that are finding banks to be complicit in illicit money flows and capital flight. The main focus is on politically exposed persons and their looting of their countries. While large amounts disappear from Africa each year due to PEPs, there are other actors as well that would be important to examine closer. Who are the main actors involved in illicit flows? Who are channelling most capital out of the various African countries?

(iv) Asset recovery

The literature on asset recovery is a combination of technical guidebooks and policy debates considering challenges connected to confiscated funds and who and how to repatriate the funds.

“The major obstacles to the recovery of stolen assets are said to be the lack of capacity in developing countries to negotiate the complex legal issues, and the uninterest shown by some developed countries in assisting the repatriation process” (Chaikin and Sharman, 2009:42).

The recovery of illicitly transferred capital requires the collaboration of banks in different countries for information sharing with the authorities, and, importantly, for not facilitating the rapid movement of detected funds to new hidden accounts and secret destinations. Repeatedly, investigators experience that banks only give a minimum of the information required and often stall the process as long as possible, to allow their clients' time to relocate their assets (Basel Institute on Governance, 2009; Daniel et al., 2008/09; Dulin and Mercaert, 2009; Fofack and Ndikumana, 2009;

Greenberg et al., 2009; Jimu, 2009; Pieth, 2008). In **‘Recovery of proceeds of crime: observations on practical challenges in sub-Saharan Africa’** Goredema (2009:34-35) concludes that effective strategies and laws to trace illicit financial flows are still inadequate in the region. Within sub-Saharan Africa there are large regulatory loopholes, such as in Angola, the Democratic Republic of the Congo, Malawi and Zimbabwe. The countries that have strengthened their legislation to create greater leeway to law enforcement, such as South Africa, Botswana, Swaziland and Tanzania, do not seem to have managed to turn theory into practice and improve significantly. The Abacha case provides an enlightening example of how Western banks gave special privileges to powerful customers (PANA, 2005; Daniel et al., 2008/09; BBC, 2001; BBC, 2000; BBC, 2002; Gert, 1999).

This chapter has given an overview of the literature on how banks assist capital flight from Africa. Accordingly, money laundering, secrecy jurisdictions, due diligence and asset recovery have been discussed. The next chapter focuses on how illicit flows are channelled out of the country of origin.

4 Capital flight – with a little help from the banks

“The management of the payment system places banks in a crucial position with respect to the money laundering activity” (Masciandro, 2007:29).

The literature on money laundering contains detailed descriptions on how financial capital is moved out of Africa illicitly with the banks as a tool. The US Permanent Subcommittee on Investigations (1999, 2003, 2006, 2008) provides good overviews over characteristics of the banking system that may facilitate illicit activities. Some of these features are summarised in the table below. The information is gathered from extensive criminal investigations on illicit money flows from a wide range of banks and countries, including Nigeria and Gabon.

Examples of banking features used for illicit transfers of funds	
Feature	How it may facilitate illicit activity
Multiple accounts Banker opens multiple accounts in multiple names in multiple jurisdictions for clients	Impedes monitoring and tracing client activity and assets and allows quick, confidential movement of funds. May hide or facilitate illicit activity
Offshore accounts “Shell” corporations or trusts formed to hold client assets offshore. Banker opens accounts in name of offshore entities	Impedes monitoring and tracing client activity and assets. May hide or facilitate illicit activity
Special name or numbered accounts Banker opens account in code name	Impedes monitoring and tracing client activity and assets. May hide or facilitate illicit activity
Wire transfers Banker facilitates complex wire transfers from multiple accounts to multiple destinations with substantial amounts	Allows quick, complex movement of substantial funds across jurisdictional lines
Concentration accounts Banker conducts client business through one single account that facilitates the processing and settlement of multiple individual customer transactions. The account that commingles the funds is used for internal purposes of the bank, but it can also be a method of hiding the origin of funds	Impedes monitoring and tracing of client activity and assets. May hide or facilitate illicit activity
Offshore recordkeeping Bank maintains client records offshore and minimizes or eliminates information in the country of residence	Impedes bank, regulatory and law enforcement oversight
Secrecy jurisdictions Bank conducts business in a jurisdiction which criminalizes disclosure of bank information and bars bank regulators from some other countries	Impedes bank, regulatory and law enforcement oversight

Source: US Permanent subcommittee on investigations (1999:45).

Investigations of money laundering and of PEPs stealing public funds provide insights on the methods used to hide the true origin of the funds and the rightful owners. Banks are often involved in only parts of the money laundering chain and the placement of illicitly gained cash. Thus, improved regulation of the banking sector will only contribute to solve part of the problem (Tax Justice Network and Christian Aid, 2009; Block and Weaver, 2004; Mikuriya, 2009; Global Witness et al., 2009).

A newer banking feature, mobile banking, should be added to the list above. The use of cell phones has opened new possibilities for millions of Africans who were previously without access to banking facilities. South Africa, Cote d'Ivoire, Zambia, Zimbabwe and the Democratic Republic of Congo (DRC) are some of the countries where the service is operating. The cell phone banking facility does not require a pre-existing bank account, and the customer is allowed to open an account without a permanent address. According to Nefdt (2008), the mobile phone service is advantageous to users, but it also opens avenues of exploitation by criminals wishing to launder money without the scrutiny of a bank with regular Know Your Customer routines.

The features listed above are commonly used by both legitimate customers and by those channelling illicit flows out of a country. Thus, the use of the service in itself is not necessarily a warning sign. The FATF and the Bank of International Settlements (BIS) have both released lists of what should be regarded to be suspicious activity.

Suspicious customer activity in banks	
FATF	BIS
<ul style="list-style-type: none"> • Unusual business activity • Unable to ascertain source of funds • Multiple deposits at different branches • Third party deposits in US dollar cash • Wire transfers following cash deposits • Wire transfers to specific location/accounts on a regular basis • Large cash deposits 	<ul style="list-style-type: none"> • Missing documents for identification of customer • Transactions with no obvious economic or commercial sense • Large cash deposits not consistent with normal and expected behaviour • Very high account turnover that is inconsistent with the size of the balance • Transactions through a customer account that is unusual
<i>Source: FATF (2008:31)</i>	<i>Source: BIS (2001:13)</i>

The table maps the most typical methods of channelling illicit funds through the formal banking system. The listed mechanisms are all documented in the literature. Typically banks in secrecy jurisdictions are used. The level of sophistication varies, and the most complex schemes include multiple jurisdictions and a large number of bank accounts in an array of banks. In many high-level cases the money is moved through a maze of shell companies and respectable nominees. Collusion with bank employees at all levels is often found (UNODC, 1998:71-73). As discussed above, the legitimacy of banking in secrecy jurisdiction is one of the most controversial topics in the literature. Also supporters of the secrecy structures do not deny that the features offered might facilitate illicit activity. Their argument, however, is that the secrecy jurisdictions are legitimate and that businesses using these services should not automatically be marked as suspicious or criminals (Christensen, 2009; NHO, 2009).

Among other features offered by banks, trusts are heavily criticised since identification of the true beneficiary of the funds is often very difficult. The trust service in itself is not necessarily hiding criminal activity. For example, a trust can be established to provide for people who are not yet born. Still, the trust structure allows transfers of funds that cannot be checked for due diligence and Know Your Customer requirements (NOU, 2009).

A case study from Nigeria

Ajayi (2000: 227-229) explains the most common methods of illicit financial flows from Nigeria:

- Carry cash out of the country and change the money into other currencies abroad
- Smuggling of values across borders in the form of easily transportable valuables such as precious metals and collectibles, for example gold, silver, art and jewellery. Since this method involves smuggling, no banks in the home country need to be involved
- Transfer pricing: Systematic overpricing and underinvoicing in trade transactions. The foreign buyer puts the difference in the price and payment into a foreign bank account in the exporter's name
- Underground banking where movement of capital is done in a system independent of the official banking system in the country
- Transferring money overseas through commissions and agent fees paid by foreign contractors into foreign bank accounts of residents
- Bank transfers from a local affiliate of a foreign institution to a designated recipient abroad

The methods listed above provide important insights into the role of banks in facilitating illicit financial flows, though several of the methods may not involve banks directly. However, current knowledge of underground banking is limited. Although the mechanisms and systems are relatively well known in literature (McCusker, 2005; Passas, 2003; 2006) the interaction between formal banks and underground banks requires further exploration. One important issue for research is whether the activity of underground banks increases when stronger regulations are imposed on the formal banking sector.

5 Relevant organisations and institutions

A wide range of international organisations are occupied with bank regulations and the challenges connected to illicit financial flows. The following table lists the most important ones. A short description of key activities of each organisation is included. More detailed information can be accessed via the organisations' web links.

Initiative	Description	Link
Action Aid	Anti-poverty agency that has been engaged in issues on tax evasion and international financial structures	www.actionaid.org
Bank for International Settlements (BIS)	International organisation which fosters international monetary and financial cooperation and serves as a bank for central banks	www.bis.org/
Basel Committee on Banking Supervision (BCBS)	Provides a forum for regular cooperation on banking supervisory matters	www.bis.org/bcbs/index.htm
Basel Institute on Governance	Independent non-profit institution devoted to interdisciplinary research, policy advice and capacity building in the areas of public, corporate, and global governance (Center for Governance and Research), and offers special services in the field of asset recovery (International Center for Asset Recovery)	www.baselgovernance.org/
Christian Aid	International NGO working to fight poverty. Illicit financial flows and tax evasion are addressed in several publications	www.christianaid.org.uk/
Committee on Payment and Settlement Systems (CPSS)	Aims to strengthening the financial market infrastructure through promotion of sound and efficient payment and settlement systems	www.bis.org/cpss/index.htm
Committee on the Global Financial System (CGFS)	Monitors developments in global financial markets for central bank Governors	www.bis.org/cgfs/index.htm
Eastern and Southern Africa Money Laundering Group (ESAAMLG)	Membership organisation for jurisdictions in Eastern and Southern Africa working together for prevention and control of the laundering of the proceeds of serious crimes	www.esaamlg.org/
Egmont Group For Financial Intelligence Units (FIUs)	Informal international association of FIUs	www.egmontgroup.org

Initiative	Description	Link
Financial Action Task Force on Money Laundering (FATF)	Inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing. FATF 40+9 recommendations call for countries to operate FIUs that meet the Egmont Group's definition	www.fatf-gafi.org
Financial Stability Board	Established to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability	www.financialstabilityboard.org/index.htm
Global Financial Integrity (GFI) and the Task Force on Financial Integrity and Economic Development	Promotes national and multilateral policies, safeguards, and agreements aimed at curtailing the cross-border flow of illegal money. The Task Force on Financial Integrity and Economic Development, initiated by GFI in 2009, is a coalition of civil society organisations and governments that work to address inequalities in the financial system	www.gfip.org/
Global Witness	NGO which investigates and campaigns to prevent natural resource-related conflict and corruption	www.globalwitness.org
International Monetary Fund (IMF)	Publishes assessments of financial sectors in African countries and engages in Anti-money laundering/Combating the financing of terrorism	www.imf.org/external/np/leg/amlcft/eng/aml1.htm#customer
IMF and the World Bank	Financial sector assessment programme (FSAP). The programme brings together World Bank and IMF expertise to help countries reduce the likelihood and severity of financial sector crises	www.worldbank.org/fsap
Information Portal on Corruption in Africa	Online resource portal on anti-corruption and democratic governance in Africa	www.ipocafrika.org
Institute for Security Studies (ISS)	Applied, policy oriented research institute operating across sub-Saharan Africa. The Cape Town branch of ISS runs two major programmes on 'Organised crime and money laundering' and 'Governance and anti-corruption'	www.issafrica.org
International Organization of Securities Commissions (IOSCO)	Membership organisation for jurisdictions to promote high standards, integrity and collaboration on market development	www.iosco.org

Initiative	Description	Link
Interpol	The world's largest international police organisation, with 188 member countries. Facilitates cross-border police co-operation, and supports and assists all organisations, authorities and services whose mission is to prevent or combat international crime	www.interpol.org
Mauritius: Financial Intelligence Unit (FIU)	Financial intelligence unit	www.fiumauritius.org/
MONEYVAL; Council of Europe	Select Committee of Experts on the Evaluation of Anti-Money Laundering	www.coe.int/t/dghl/monitoring/moneyval/
Nigeria: Financial Intelligence Unit	Financial intelligence unit	www.efccnigeria.org/index.php?option=com_docman&task=catt_view&gid=18
Organisation for Economic Coordination and Development (OECD)	Involved in most aspects concerning the fight against illicit financial flows, anti-corruption, tax evasion, money laundering, terrorist financing and asset recovery. The web page is a good resource for publications, statistics and information	www.oecd.org
South Africa: Financial Intelligence Centre (FIC)	Financial intelligence unit	www.fic.gov.za/
Stolen Asset Recovery Initiative (StAR)	Partnership between the United Nations Office on Drugs and Crime (UNODC) and the World Bank. Aims to encourage and facilitate more systematic and timely return of assets stolen by politically exposed persons through acts of corruption	http://go.worldbank.org/R9J4H6T3G0
The Norwegian Government's Expert Commission of Inquiry into Capital Flight from Developing Countries	Expert commission on tax havens and development	www.norad.no/Satsingsomr%C3%A5der/Korrupsjonsbekjempelse/Offentlig+utvalg+mot+kapitalflukt+og+skatteparadis/121536.cms
Tax Research Limited	Private company researching and advising on tax issues and other aspects of governance. Directed by chartered accountant Richard Murphy	www.taxresearch.org.uk/
Tax Justice Network	Independent organisation which conducts research, analysis and advocacy in the field of taxation and regulation, including the developmental impacts of tax evasion and tax havens	www.taxjustice.net

Initiative	Description	Link
International Money Laundering Information Network (IMoLIN)	Internet based network of organisations and individuals	www.imolin.org/
U4	Anti-corruption resource centre serving bilateral donors. Located at Chr. Michelsen Institute, Norway	www.U4.no
United Nations Office on Drugs and Crime (UNODC)	Established in 1997 and operates in all regions of the world through an extensive network of field offices. Mandated to assist member states in their struggle against illicit drugs, crime and terrorism through technical cooperation and analytical work	www.unodc.org
US Senate Permanent Subcommittee on Investigations	Investigation of cases linked to the U.S.	http://hsgac.senate.gov/public/index.cfm?FuseAction=Subcommittees.Investigations

Source: The table is compiled by the authors

6 Policy relevance of the reviewed literature

Recommendations from the literature tend to reflect the complex web of actors involved in the moving, hiding and laundering of illicit financial flows. Policy advice can be categorised into recommendations for (i) private companies, (ii) national governments, (iii) international organisations, and (iv) commercial banks. For development agencies the literature provides advice that can be implemented in collaboration with international organisations, the donor's own government and with the partner government or civil society organisations in the host country. The specific country setting should be considered when development partners decide who will be the best partner when addressing capital flight challenges. As argued by Goredema and Madzima (2009), the high levels of corruption that often is linked to capital flight from Africa are likely to put severe constraints on the implementation of reforms.

Recommendations for banking institutions

- Clear control mechanisms, policies and procedures to manage risk of money laundering may help bank staff and management to address and mitigate risk
- Regular training of staff in due diligence and 'know your customer' (KYC) principles will give bank officers better knowledge on how to meet the official requirements in practice
- Establishment of comprehensive KYC routines could help to detect suspicious transaction and to give guidance on how to act when discovered
- Reporting routines to relevant authorities such as the Central Bank or the Financial Intelligence Unit could be established to make the process more streamlined for the bank personnel
- Compliance officers at the management level may be given the responsibility to ensure that the regulatory framework is used in practice to signal that the area is a priority in the institution

Recommendations for governments and development agencies

- Illicit flows out of the developing world are a cross-ministerial issue for governments. Development agencies could therefore benefit from approaching a wide range of institutions in the country they are working in. As an example, counterparts in the treasury, justice, foreign and trade ministries can potentially all be key to coordinate an approach to money laundering, corruption and capital flight challenges
- Asset recovery cases may require extensive juridical knowledge, capacity and resources. Donor agencies could therefore play a role in supporting governments in developing countries to build national capacity on asset recovery, provide professional assistance and other resources required to follow up asset recovery cases
- UNCAC and FATF recommendations may be easier to follow in practice if governments agree on an effective review mechanism
- FATF member governments could use their position within FATF to make fighting corruption a priority and to ensure that FATF members comply with the standards
- Capacity building and training of bank personnel in due diligence and KYC principles and the rationale behind why these are important could be supported by donor agencies in collaboration with the bank sector
- Identification of bank customers will be more secure with nationally approved and standardised identification papers. Donor agencies could potentially assist government effort to develop the system if requested

- Governments can establish legislation that makes aggressive, personal marketing of banking in tax havens within the boundaries of their country more difficult

Recommendations for international organisations

- FATF should assess whether their guidelines are sufficiently addressing the particular context of African economies which are (a) largely cash based, (b) there is a heavy reliance on a parallel, informal banking system, and (c) informal value transfer methods are the norm
- NGOs and the media may play an important role in informing civil society of corrupt actions of PEPs by publishing knowledge that are made easily available for the public

7 Issues for further research

The review clearly shows that there is a need for more in-depth and detailed knowledge on how banks are involved in and facilitate capital flight from Africa. The level of development and the structure of the banking sector vary substantially across Africa. Hence, there is a need to move beyond regional generalisations and averages, and to focus more on country specific issues. In particular, studies of the relationships between formal and underground banks in individual countries, and the relationships between these ‘onshore’ banks and financial institutions in secrecy jurisdictions, are likely to generate relevant insights for policy design based on solid understanding of the mechanisms applied by banks. Such studies may shed light on the linkages between financial institutions of various types (e.g. formal and informal banks, exchange bureaus, etc) and finance institutions at various levels (local, national, regional, international and offshore). Much of the current debate, however, focuses mainly on financial centres in secrecy jurisdictions. It is also important to gain better understanding of how banks with branches in different African countries operate in different settings, and what regulatory frameworks they apply.

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Systematic studies of the banking sector's involvement in facilitating capital flight from developing countries are limited. This report was commissioned by Norad's Anti-Corruption Project (ANKOR) for the purpose of summarising key lessons from the existing literature and to identifying knowledge gaps. The study focuses on capital flight from Africa. It is a desk study, based on a review of library and online literature databases and reports and documentation from national and international organisations. The review demonstrates that banks should not be disregarded as passive players when analysing capital flight. Banks play an active role in facilitating capital flight from Africa. However, to improve the regulation of the banking and finance sectors, there is a need for more detailed knowledge on how banks actually operate as facilitators and the mechanisms applied.