

Money laundering and the role of offshore financial centres

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Generally

Money laundering refers to the transformation of the proceeds of criminal activity into untainted, innocent money that bears no traces of its illegitimate origin. Laundering money hides or disguises untaxed and otherwise illegitimate income from tax collectors and law enforcement. The term “money laundering” involves all the activities and processes, acts and omissions that alter the identity of illegally acquired money into legitimate investments or income that seems to be obtained from a legitimate source.¹ More recently, the term has been referred to money secretly channeled into financing terrorists.²

We cannot be really sure when money laundering started. However, we can be confident that it has been going on for several thousand years. Sterling Seagrave³ explains how 2000 years BC merchants in China would hide their wealth from rulers who would simply take it off them and banish them. In addition to hiding it, they would move it and invest it in businesses in remote provinces or even outside China. That is how offshore industry and tax evasion were born. And so were

¹ Larry Allen, *The Encyclopedia of Money*, 2009, p. 292. Kenneth A. Reinert, Ramkishen S. Rajan, *The Princeton Encyclopedia of the World Economy*, 2009, p. 785.

² Money laundering makes it more difficult to trace the origin of terrorist activity.

³ *Lords of the Rim*, 1995.

the principles of money laundering, i.e. to hide, move and invest wealth to which someone else has a claim.⁴

The term “money laundering” was first coined at the beginning of the 20th Century. More specifically, it is derived from the habit of the gangster Alphonse ‘Al’ Capone⁵ funneling his ill-gotten gains through laundrettes to construct the pretence of a legitimate income. This metaphor of dirty money, income, proceeds or whatever being washed in order to become white or clean, is still adequate for all definitions of money laundering.⁶ Later, Meyer Lansky, in order to avoid a possible prosecution for tax evasion, transferred the illegal earnings from his growing casino empire to a Swiss numbered bank account, where anonymity was assured by the 1934 Swiss Banking Act. Lansky eventually even bought an offshore bank in Switzerland, which he used to launder money through a network of shell and holding companies.⁷ Today, Lansky can be credited for establishing the modern form of money laundering and tax evasion.⁸

Models and Stages of Money Laundering

Money laundering is an international scale process of “recycling dirty money” and during this process concrete actions are repeated, so it is conducive to systematize these actions in a model. Different models have thrived, as Zünd’s, in which the circulatory system of money laundering from criminal activities is likened to that of the hydrological system. This is a model which addresses money laundering as a closed recycling process and, by simplifying it, satisfactorily captures

⁴ Nigel Morris-Cotterill, *A Brief History of Money Laundering*, 1999.

⁵ In 1931, Al Capone was sentenced for tax evasion.

⁶ B. Unger, M. Siegel, J. Ferwerda, W. De Kruijf, M. Busuioic, K. Wokke & G. Rawlings, ‘The amounts and the effects of money laundering’. Report for the Ministry of Finance, February 16, 2006, p. 20.

⁷ Lucy Komisar, ‘Offshore banking: the secret threat to America’, *Dissent Magazine*, Spring 2003.

⁸ The extent and sophistication of his operations may never be fully understood as most of them still remain undetected.

the activities of money laundering. In that way, it also takes for granted that criminal assets are solely invested back to new criminal activity. Moreover, Jürg-Beat Ackermann and James Preston propounded the teleological model, which focuses on the purpose of money laundering. Paolo Bernasconi is the initiator of the phase model. This model separates money laundering in two degrees and differentiates between trading countries, where criminal activity takes place, and the countries where money laundering is performed.⁹

In USA and Europe the – American – model of three phases is commonly adopted. The three normally quoted stages of the process in traditional money laundering are placement, layering and integration.

The first part of the process is placement, that is getting all proceeds of crime into the world's banking system. Firstly, placement can be achieved by primary deposit, i.e. immediate placement of criminal proceeds into a financial system without attracting attention of regulatory agencies. To avoid identification, obligations to report and documentation required, limited amounts are undermined by "structuring" and "smurfing"/¹⁰ Money is split up systematically in partial amounts in order to permit inpayment in bank accounts below respective identification and declaration borders. Placement can also be attained through the influencing control on financial institutes in terms of purchasing existing banks or starting-up new banks in OFCs.¹¹ As criminals have become more adept at this initial stage, they have, for instance, invested in businesses that in the normal course of events have a high physical cash flow. Examples of these cash intensive businesses are casinos, bars, retail outlets, art dealers and restaurants. If they can utilise a business type where it is accepted that cash forms the major proportion of their takings and therefore banking operations, then where cash is the base metal, it can easily be inserted in the banking

⁹ Stavros Katsios, *Money Laundering*, 1998, pp. 77-79.

¹⁰ Breaking up a large deposit into smaller deposits which helps avoid the currency transaction reporting requirements.

¹¹ Friedrich Schneider & Ursula Windischbauer, 'Money laundering: some facts', *European Journal of Law and Economics*, 2008, Springer pp. 394-395.

system. Criminals can use existing businesses, create their own or establish a totally fictitious concern that never trades but simply launders cash. They may also buy high value goods (works of art, airplanes, property, precious metals or diamonds) that sell to legitimate purchasers and thus the proceeds of crime infiltrate the banking system through a business transaction.¹²

Whether the profits of crime are in the form of cash or not, at this stage there is an increased risk¹³ for the criminals to be revealed as there exists a direct connection between the profits and the crime. Once the placement has been made money cannot be easily traced. As a result, all legislations, regulations and training against money laundering are focused on account opening procedures, such as verifications of the identity of the new customer (KYC or Know Your Customer), reporting to agencies when the initial investment is over a certain limit, training staff who deal with account opening to detect suspicious transactions.¹⁴

The second stage of the money-laundering process is layering. The goal in this stage is the concealment¹⁵ of the criminal origin of the proceeds. As long as cash is converted to a more manageable form or deposited into the financial system, the criminals must distance themselves from the illicit process. They are able to achieve this by setting complex layers of financial transactions draughtted to circumvent existing laws. Therefore, money can be transferred and split frequently between bank accounts, countries, persons or businesses. Money can also be withdrawn in cash and deposited into bank accounts with other banks. It is common to use bank accounts in countries with strict banking secrecy laws and to nominate offshore corporations as the bank ac-

¹² Peter Lilley, *Dirty Dealing: The untold truth about global money laundering, international crime and terrorism*, p. 49.

¹³ Saul M. Froomkin, 'Offshore centres and money laundering', *Journal of Money Laundering Control*, 1997, 1(2), 167.

¹⁴ Peter Lilley, *Dirty Dealing: The untold truth about global money laundering, international crime and terrorism*, p. 49.

¹⁵ This stage is the "cleaning" cycle of the money laundering process.

count holders.¹⁶ Businesses that do not accept cash or sellers of consumer durables are likely to encounter that stage of money laundering.¹⁷

The final stage is termed integration¹⁸. The process of money laundering is completed only after the criminal proceeds – having acquired legitimacy- are either transferred back to the realm of the criminal or channeled into medium-term or long-term investments. Obviously, a single concealment of criminal proceeds would serve to protect the criminal from law enforcement authorities. Yet, both the risk of loss and the need to invest these proceeds urges the criminals to integrate them into the financial system. However, given that a single hiding of those takings in a bank account is not enough to assure them, the final goal of concealing and laundering is only served by a constant channeling into financial markets.¹⁹

The complexity of the money laundering process depends on the creativity and the special needs of each criminal organisation. The money laundering needs of a large traditional organized crime family differ from those of a small cell of fundamentalist religious terrorists. The goal, though, of the money laundering process remains the same, i.e. the concealment of either the source or application of criminal proceeds²⁰.

A great variety of techniques has been devised in order to accomplish the purpose of money laundering. Offshore financial centres of OFCs occupy a neuralgic place in the whole money laundering process

¹⁶ Opacity is the key to any successful layering process.

¹⁷ Michael Zeldin, 'Money laundering', *Journal of Money Laundering Control*, 1998, 1(4), 295. OECD, *Money Laundering Awareness Handbook for Tax Examiners and Tax Auditors*, 2009, p. 13.

¹⁸ "If the layering process has succeeded, integration schemes place the laundered proceeds back into the economy in such way that they re-enter the financial systems appearing to be normal business funds", Bank of England: 'Guidance notes for banks and building societies on money laundering', December 1990, p. 2.

¹⁹ Stavros Katsios, *Money Laundering*, 1998, p. 86.

²⁰ Michael Sheetz, *Investigating Global Money Laundering, Law & Order*, Aug 2004, p. 108.

and it would be of particular interest to look into their key role.

Offshore Financial Centres (OFCs)

1. Offshore financial centres and their features

Offshore Financial Centres or OFCs,²¹ despite their name, are not necessarily islands, although many island jurisdictions have established OFCs, nor do they have a single universal definition. OFCs could be defined as places that “host financial activities that are separated from major regulating units (states) by geography and/or legislation”,²² or as jurisdictions whose financial sectors account for a significant and disproportionate share of its domestic economy, or as jurisdictions where a majority of financial transactions conducted by their institutions are done on behalf of clients who reside in other jurisdictions.

Historically, offshore jurisdictions were associated with one or more of the following: low or zero taxation, moderate financial regulation and supervision, and secrecy or anonymity in financial dealings.²³ Increasingly, many offshore centres are associated with niche markets in which they have developed extensive professional expertise.²⁴ Offshore financial activities include offshore banking (both wholesale banking such as Eurocurrency loan booking and retail banking, particularly international private banking), offshore funds, trusts, holding, financial services, licencing, trading, business administration, shipping, investments, nominees, leasing, LLCs and captive insurance.²⁵

²¹ In the past few decades, offshore financial centres were known as “tax havens”.

²² M.P. Hampton, ‘Treasure islands or fool’s gold: can and should small island economies copy Jersey?’, *World Development*, 1994, pp. 237-250.

²³ Jackie Johnson & Mark Holub, ‘Corporate flight: moving “offshore” to avoid US taxes’, *Journal of Financial Crime*, 2003, 10(3), 246.

²⁴ Not all offshore activities take place in all offshore centres.

²⁵ M.P. Hampton & M. Levi, ‘Fast spinning into oblivion? Recent developments in money-laundering policies and offshore finance centres’, *Third World Quarterly*, 1999, 20(3) 649. *The Princeton Encyclopedia of the World Economy*, 2009, p. 861. P.

Some of the main characteristics of OFCs are the following.²⁶

- Favorable tax treatment to businesses or financial investors.²⁷
- Absence of records relating to the de facto rulers of companies.
- The legislative prohibition on disclosure of information on these offshore centres.
- Their obvious reluctance to cooperate, on the grounds that in most centres tax evasion is not an offence of money laundering.
- There are no arrangements to exchange information with other countries.
- International corporations can be created with minimum formalities.
- Providing bank secrecy for these corporations.
- Very harsh laws for the breach of bank secrecy.
- A highly developed tourist activity which may justify cash inflows.
- A universal currency (particularly U.S. dollar) is used as the local currency.
- A government relatively invulnerable to external pressures.
- A high degree of economic dependence in financial services.
- Availability of modern communication systems (telephone cable, telex) that bind them to other countries.
- A favourable geographical location for business trips to rich neighbouring countries.

2. *The role of offshore financial centres in the money laundering process*

On the account of the internationalisation of currency, capital, and corporate securities markets and the ease of international travel and developments in communications, information, and technology, a very high proportion of financial crime has become transnational in conception, execution and realisation. Money laundering schemes for transna-

Douvis, *Offshore Activities*, 2008, pp. 59-112.

²⁶ Roxana Ispas, 'Money laundering through offshore areas', *Annals of the University of Petroșani, Economics*, 9(2), 2009, pp. 58-59.

²⁷ Peter Schwarz, 'Money launderers and tax havens: Two sides of the same coin?', *International Review of Law and Economics* 2011, p. 37.

tional crimes and for significant single-jurisdiction crimes will inevitably involve offshore countries, as criminals seek for more secretive places to launder dirty money.²⁸

OFCs have a central role in the whole money laundering process.²⁹ As regards to the stage of placement, the most effective technique is to smuggle funds offshore is by using a bank or a financial institution. Other ways to place money offshore include the use of false or fraudulent customs documentation, the manipulation of securities, commodities, and foreign exchange transactions, the abuse of the international airlines payment system and of course the physical transportation of cash or negotiable monetary instruments which are carried by couriers on their person or as luggage, unaccompanied baggage or freight.³⁰

A large part of the earnings of organized crime is not obtained in cash and, hence, they do not pass through the stage of placement. For instance, subsidies defrauded by criminal organizations are deposited by check or wire transfer to the account of an offshore corporation of unknown owner. Therefore, sometimes the stage of placement is omitted.³¹

Once the criminal proceeds are placed in an offshore centre, additional secrecy is obtained by agitating the proceeds through one or more laundering cycles, i.e. sending the funds across many countries and passing them through numerous hands, bank accounts, and legitimate businesses. Offshore banking plays an important role in this stage, as banks in OFCs ensuring banking secrecy purpose and protect their customer's identity by totally anonymous accounts, accounts of clients protected by an attorney, accounts of fictitious beneficiaries,

²⁸ Mary Alice Young, 'The exploitation of offshore financial centres', *Journal of Money Laundering Control*, 2013, 16(3) 201.

²⁹ Alexa Rosdol, 'Are OFCs leading the fight against money laundering?', *Journal of Money Laundering Control*, 2007, 10(3) 339.

³⁰ David A. Chaikin, 'Money laundering: an investigatory perspective', *Criminal Law Forum*, 1991, 485-486.

³¹ Chara Zerva, 'Offshore companies and money laundering', *Criminal Justice* 2001, 1046-1057.

protected secret accounts. Offshore banks attract funds largely because they promise both anonymity and the possibility of tax avoidance, and in some cases, tax evasion³². Wire and electronic funds transfers are primary tools in the stage of layering as they facilitate operations from a large number of bank accounts, into which deposits have been made by “smurfing” to a principal collecting account located in an offshore centre³³. Tainted funds can also be routed through shell corporations, which the FATF³⁴ (Financial Action Task Force) defines as a corporation or institution “that does not conduct any commercial or manufacturing business or any other form of commercial operation in the country where their registered office is located”.³⁵ Front companies can also be used to conduct international commercial trade. These companies are effective in the stage of layering³⁶ because they do not necessarily require the complicity of a financial institution and they are more difficultly detected if they conduct legitimate business, particularly ones that are exempt from Currency Transaction Reports (CTR), such as liquor stores or restaurants. Any cash rich business can serve as a front company. Import and export companies can also serve as front companies using double invoicing, under-valuation and over-valuation of goods and financing exports to launder money. Inflated prices to pay for imported goods are also a common laundering technique used by front companies³⁷.

At the final stage of integration, which is probably the smoothest

³² Phil Williams, ‘Money laundering’, *South African Journal of International Affairs*, 1997, 83.

³³ Peter Reuter, Edwin M. Truman, *Chasing dirty money*, 2004, p. 30.

³⁴ The Financial Action Task Force (on Money Laundering), also known by its French name, Groupe d’action financière (GAFI), is an intergovernmental organization founded in 1989 on the initiative of the G7 to develop policies to combat money laundering. In 2001 the purpose expanded to act on terrorism financing.

³⁵ Bonnie Buchanan, ‘Money laundering—a global obstacle’, *Research in International Business and Finance* 2004, 118.

³⁶ They are also used at the stage of integration.

³⁷ Bonnie Buchanan, ‘Money laundering—a global obstacle’, *Research in International Business and Finance* 2004, 118.

part, the mirror-image trading scheme is central. It involves buying contracts for one account while selling an equal number of contracts from another³⁸. The same person controls both accounts, thus any profit or loss is effectively netted. At this phase, an offshore business is contracted to a legitimate and finally illicit proceeds take the form of the product or profit from a legitimate transaction.

3. How do criminals choose an offshore financial centre?

Considering the main features of OFCs and the purpose of money laundering, the following factors, reasons and causes that make some OFCs attractive to money laundering can be drawn.³⁹ Therefore, crime organizations seek for OFCs:

- With absolutely or very strict banking secrecy, which is not abrogated to detect crimes, either felonies.
- With banking systems do not require verification of customer 's identity, or banks that make extensive use of codes or anonymous accounts or credit nominee accounts.
- Where there are no or lax controls on foreign exchange.
- With lax corporate legislation and simple to start-ups, particularly where there is shareholder anonymity.
- With financial systems which allow extensive use of monetary instruments in bearer.
- With any controls on imports and exports of cash.
- Where money laundering is not a crime.
- Where financial businesses that are not subject to any kind of control or supervision operate.
- Where there is no recording of large amounts of cash transactions.
- Where no obligation to report suspicious transactions to national agencies or authorities is imposed.

³⁸ Bonnie Buchanan, 'Money laundering—a global obstacle', *Research in International Business and Finance* 2004, 119.

³⁹ George Tragakis, *Organised Crime and Money Laundering*, 1996, pp. 190-192. W. Filipkowski, *New trends on money laundering, Criminal Justice*, 2005, pp. 883-891.

- With legal systems that do not provide seizures or confiscations of property.
- With weak or transparent financial supervisory rules and agencies, particularly where there is no or deficiently trained personnel.
- Where law enforcement agencies, i.e. police, customs authority and coastguard lack in personnel or equipment.
- With offshore banking systems where establishing a corporation or open an account is easy and inexpensive.
- With free trade zones, where there is hardly any state control or supervision.
- With legal systems that encourage access to international gold trading centers.
- With extensive activity of foreign banks, i.e. where foreign banks have established branches or subsidiaries and there is business development through wire transfers.
- With ineffective or corrupted public administration or where business and financial communities follow a 'laissez faire' policy and methods of unfair competition.
- With an unusually large volume of interbank transfers of fiduciary money and financial payment instruments.
- Where US dollar and other strong currencies are directly accepted, particularly where banks and other financial institutions may open deposit accounts in dollars or other strong currencies.

4. The Panama Papers case

The most recent case that captures the central role of offshore financial centres, concerning not only money laundering but the whole global economy, is the Panama Papers case. The Panama Papers are an unprecedented leak of 11.5 millions files from the database of the world's fourth biggest offshore law firm, Mossack Fonseca, which is a Panama-based law firm and whose services include incorporating companies in offshore jurisdictions, such as the British Virgin Islands, and wealth management.

Mossack Fonseca data relates to more than 200,000 companies for

which the firm acted as registered agent. Often used lawfully to anonymously hold property and bank accounts, these companies were registered in a range of OFCs and this map depicts the most popular locations among its clients. The British Virgin Islands held more than 100,000 companies. Rather than dealing directly with company owners, Mossack Fonseca mostly acted on instructions from intermediaries, usually accountants, lawyers, banks and trust companies.⁴⁰

The files expose the offshore holdings of twelve current and former world leaders and contain new details about major scandals ranging from England's most infamous gold heist, an unfolding political money laundering affair in Brazil and bribery allegations convulsing FIFA, the body that rules international soccer. They also provide details of the hidden financial dealings of 128 other politicians and public officials around the world and point how a global industry of law firms and big banks sells financial secrecy to fraudsters and drug traffickers as well as billionaires, celebrities and sports stars. The Panama Papers also include the names of at least 33 people and companies blacklisted by the U.S. government because of evidence that they have done business with Mexican drug lords, terrorist organizations like Hezbollah or rogue nations, including North Korea and Iran. The leaked data covers nearly 40 years, from the late 1970s through the end of 2015. It allows an unprecedented view inside the offshore world, providing a day-to-day, decade-by-decade look at how dark money flows through the global financial system, breeding crime and depriving national treasuries of tax revenues.⁴¹

The Panama Papers case establishes with emphasis that regardless of the fact that OFCs were conjured after World War II, nonetheless,

⁴⁰ J. Garside, L. Harding, H. Watt, D. Pegg, H. Bengtsson, S. Bowers, O. Gibson & N. Hopkins, 'What are the Panama Papers? A guide to history's biggest data leak', *The Guardian* 2016-04-05. <https://www.theguardian.com/news/2016/apr/03/what-you-need-to-know-about-the-panama-papers>

⁴¹ The International Consortium of Investigative Journalists, 'Offshore links of more than 140 politicians and officials exposed', 2016-04-03. <https://www.icij.org/blog/2016/04/offshore-links-more-140-politicians-and-officials-exposed>

nowadays, they keep serving purposes of money laundering in a most complex economical and financial environment. It is remarkable that European Commission has announced it will tighten the European Union's anti-money laundering rules and increase transparency requirements for companies and trusts, putting the financing of terrorism and tax evasion in its crosshairs.⁴²

⁴² Simon Bouvier, 'Panama Papers credited as new EU anti money-laundering and tax abuse rules proposed', *ICIJ* The International Consortium of Investigative Journalists, 2016-07-07. <https://panamapapers.icij.org/20160707-eu-tax-AML-rules.html>

