Transparency and Incentives: Are the Black Lists an Effective Device?

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Motivation

- From the EATLP2018 Report:
  - “Blacklists are an interesting to set tax havens under pressure” (…)
  - “They provide a disincentive for investment in tax havens” (…)
  - “By these disadvantages, being mentioned in a black list hampers the business model of tax havens”
- Are you sure?
Motivation

- Time to time news – as the April 2016 revelations in the Panama Papers, or the May 2018 news on the UK amendment to its AML bill – spotlighted the role that banking secrecy - which is offered in so called tax and financial centres and territories - perform in the global economy.

- The facts have caused increasing concern that banking secrecy lies at the centre of an international web of illegal and criminal conduct.

- In parallel, several policymakers in advanced countries have emphasised the need for enforcing the blacklisting tool against the territories that breach transparency standards.

- But does blacklisting work?
Background Papers

- Papers:
Setup

- Principles: Economics & Politics
- Empirics
Principles: The Evergreen Banking Secrecy

- Banking secrecy is an evergreen issue in the national and international arenas.
- In the aftermath of the Global Financial Crisis the fight against bank secrecy as well as against banking secrecy havens has become a political priority in advanced countries.
- It is often the case that international organisations as well as national governments do not have strong legal instruments to impose strict measures to prevent and combat banking secrecy.
- For this reason, soft law practices, such as blacklisting, have been introduced.
Principles: Blacklisting as an Incentive Device

- The aim of the soft law tools is to put the investigated country under intense international financial pressures, using the “name and shame” approach.
- Under “name and shame approach” institutional regulatory organizations and/or national governments disclose names of non-compliant countries and/or non-compliant banks to the public, supplementing the disclosure with forms of official opprobrium.
- This approach has been increasingly applied in the international context to address policy coordination problems among national policymakers and regulators.
- The aim of a listing procedure is to put Black-Listed Countries (BLCs) under intense international financial pressure, by employing the “name and shame” approach in order to produce the so-called stigma effect.
Blacklisting: Economics ...

- By stigma effect we understand an inverse relationship between blacklisting and illegal international capital flows: the event of being blacklisted decreases the international capital flows to a country.
- Various sources of pressures on a BLC are expected to work
- First, most countries interacting with BLC evaluate their financial transactions as that are thought to be suspicious. It leads to more stringent and costly monitoring. Banks operating in multiple jurisdictions get more concerned by monetary costs, including compliance costs
Blacklisting: Economics ...

- Furthermore, financial transactions with a BLC can imply **reputational costs**
- Suspicious financial transactions attract more and more attention from supranational organizations, national policymakers and regulators, and international media
- For a banking institution, engagement in opaque financial transactions can increase reputational risks
- Just to cite the more recent and meaningful episodes, from 2012 various international banks were investigated for alleged illicit financial transactions and/or fined, and/or solicited to improve compliance; Transactions with BLCs can produce similar negative reputational effects
Blacklisting: ... and Politics

- But both the existence and the direction of the stigma effect are far from obvious.
- The AML/CFT non-compliance of a country can be attractive under specific conditions, such as the potential existence of worldwide demand for non-transparent financial transactions.
- A BLC can be attractive for banking and non-banking institutions seeking to promote lightly regulated products and services to their wealthy and/or sophisticated clients.
- The international banking industry can have incentives to take advantage from the existence of BLCs.
Blacklisting: ... and Politics

- Therefore the stigma effect, meant to be “a stick”, can turn into “a carrot”
- The *stigma paradox* can thus emerge, as a specific case of regulatory arbitrage that creates the so-called “race to the bottom” strategy, which implies the desire to elude more prudent regulation
Empirics

- Masciandaro and Balakina (2016) evaluated empirically the trend, magnitude and robustness of the stigma effect.
- By focusing on the effect of FATF blacklisting on the relationships between international financial institutions and BLC banking systems.
- They analysed the relationship between international capital movements and FATF listing/delisting events in 126 countries in the years from 1996 to 2014.
Empirics

- The variable of interest is the dummy variable -- **FATF** -- which is equal to 1 if the country is listed in the Financial Action Task Force list of "Non-Cooperative Countries or Territories" and 0 if the country complies with FATF conditions.

- The FATF variable is constructed using Financial Action Task Force reports "Review to Identify Non-Cooperative countries or Territories: Increasing the Worldwide Effectiveness of Anti-Money Laundering Measures", published annually in June by the FATF.

- The Financial Task Force List consists of countries perceived to be non-cooperative in the global fight against money laundering and terrorist financing.

- The FATF has created a list of recommendations, which includes 40 recommendations on money laundering and nine Special Recommendations on Terrorist Financing. The lack of cooperation of those countries manifests itself as unwillingness or inability to follow FATF recommendations.
Empirics

- The international capital flow measure is the growth rate of total foreign claims obtained from the BIS database.

- Figure 1 represents the average value of International Bank Flows for all 126 countries for the period from 1996 till 2014.

![Graph showing the average value of International Bank Flow, 1996-2014](image-url)

Figure 1. Average value of International Bank Flow, 1996-2014
Empirics

- In total 45 countries were listed during the existence of the FATF List, 10 of these countries are developed, according to World Bank Lists for the time period 1996-2014.

Figure 1: Blacklisted Countries
Empirics

- The stigma effect holds if a listing event is negatively associated with the capital flows.
- The visual description of the capital flows of the listed countries during the listing period (Figure 2) casts doubts on the robustness of the stigma effect.

Figure 2: Capital Flows in Blacklisted Countries during the Listing Period
Empirics

- The econometric analysis confirmed that, in general, the stigma effect does not exist.
- In fact, the empirical analysis shed light on the fact that the FATF variable can be positive and statistically and economically significant.
- It means that not only does the stigma effect not exist in a systematic way.
- On the contrary, being listed can be considered in some occasions as a sign of the possibility to get additional profits.
Conclusion

- Is the era of banking secrecy definitively over, as a G20 official document stated in 2009? Probably not
- If it is assumed that banking secrecy is the result of market mechanisms, it is easy to discover that the worldwide demand and supply of banking secrecy are likely to be relevant for a long time to come
- The empirical analysis tested whether international banking activities respond to the “name and shame” approach, which has been introduced to combat money laundering and terrorism finance
- To understand the effects that FATF decisions have on listed countries, the econometric analysis has been focused on how banks react to higher potential costs that can emerge (disappear) when a country is listed (delisted), finding that the stigma effect is weak
Conclusion

- The bottom line is that the growth of criminal and illegal activities systematically generates the demand of banking secrecy.
- While economic and political incentives can motivate national politicians and international banks to supply banking secrecy.
- Applying the tools of economics and political economy, it is possible to show that so far international efforts to combat banking secrecy are likely to be ineffective or even worse counterproductive.
- Banking secrecy is unlikely to disappear; it is more true to describe it as a dynamic variable with its booms and busts motivated by the changing preferences of both offshore and onshore policymakers.
- Banking secrecy is a like a tango: it takes two to dance it.
Conclusion

- Therefore the EATLP2018 Report conclusion that:

- “(...) possible purposes and effects of such lists need to be understood in a more profound way”

- It seems to me prudent and wise