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Terrorism Financing and Financial System Vulnerabilities: Issues and Challenges

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Abstract

Terrorist activities require access to funds at all stages of planning preceding an attack. This paper reviews the fraudulent acquisition of funds by terrorists and the potential vulnerabilities of our financial system.

Introduction

Foreign exchange transactions now amount to more than a trillion dollars a day, and this movement of funds not only yields profits to those who move them, but also helps to finance international transactions, and provides capital to those who require it for investment. The extent to which capital should be allowed to move freely has been a subject of debate among economists, especially after the Asian financial crisis of 1997-98; for example, Bhagwati (1998), one of the foremost international trade theorist of his generation, has argued that the case for free capital mobility is less persuasive than the case for free trade[1]. Yet, many developing countries continue to embrace capital mobility by encouraging foreign investment in stock and bond markets. Despite doubts regarding the benefits of free capital mobility, the world has increasingly liberalized capital flows among countries, which is a defining characteristic of the globalization of the world economy.

The current structure of the global financial system is in part a reflection of the desire of financial actors to keep regulations at a minimum (or avoid them altogether), thus allowing the market to allocate resources in the most efficient way. Furthermore, a number of studies have also confirmed a positive relationship between the level of financial sector development and economic growth. In a well-cited study, King and Levine (1993) use data on eighty countries over the period 1960-89 and provide evidence consistent with Joseph Schumpeter's view that the financial system can promote economic growth[2]. Focusing attention on what happens to the financial system as a result of new regulations, and assessing and correcting its vulnerabilities, is therefore important.

Some of the funds that are transacted in interconnected global capital markets are inevitably related to illegal activities such as tax evasion, money-laundering, and terrorism financing. This paper focuses on the latter. More specifically, given that terrorist activities require access to funds at all stages of planning preceding an attack, this paper will review the fraudulent acquisition of funds by terrorists and the potential vulnerabilities of our financial system. It becomes clear, however, that given the magnitude of capital flows, the increasing integration of financial systems, and the speed with which these flows can be moved between jurisdictions as a result of improved information technology, tracing terrorist funds represents a major challenge that can be extremely costly.

Skeptics will argue that disrupting or stopping flows of funds intended for terrorist activities is in fact too costly and that too many regulations may hinder the normal workings of the financial system[3]. Indeed, we may never know how much of these funds we will be able to trace or disrupt, and the war on terrorism financing may never be won completely, but the effort has to be made for a number of reasons. First, cutting access to funds by terrorists can pre-emptively prevent future terrorist attacks and save lives by destroying or degrading their operational capabilities, regardless of the results from cost-benefit analyses of regulations. Secondly, stopping the flow of funds to terrorists may disrupt their organizational abilities to form future alliances, build infrastructure for recruitment and training, and buy or develop deadly weapons. Thirdly, even if the funds disrupted or assets seized may be insignificant, the information contained in money flows may be more important than the flows themselves, and needs to be studied, especially when this intelligence is not available from other sources. Following the money trail thus represents a critical investigative tool in the war against terrorism, and efforts against terrorist financing should be aimed at better understanding how terrorists operate so that they (and the organizations to which they belong) can be disrupted or prevented.

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The rest of this paper proceeds as follows: Section 2 defines the main terms that will be used in this paper, and the principal actors involved in the fight against terrorism financing. Section 3 examines the relationship between money-laundering and terrorism financing, and the fraudulent acquisition of funds by terrorists. Section 4 analyzes the vulnerabilities in the financial system, and Section 5 concludes with some policy implications.

Terminology and Main Actors

It is important to clarify some of the terms that we will be using in this paper, as well as identify some of the important actors and their roles in leading the fight against the financing of terrorism. The financial system in this paper consists of formal (such as banks, insurance companies, stock exchanges and offshore financial services) and informal (such as alternative remittance systems) institutions that allow the movement of funds, domestically and internationally.

The international community has tried unsuccessfully to reach a consensus on the definition of terrorism for many years, and use of the term remains controversial, so much so that many prefer to use other terms such as 'bomber' or 'killer'. Differentiating terrorism from a liberation or resistance struggle remains a contentious point (hence, the often-heard remark that one man's terrorist is another man's freedom fighter). Although my intention is not to pursue this debate further, based on numerous definitions that exist, the term "terrorism" in this paper will refer to calculated acts of violence against civilian targets based on political, religious or ideological beliefs, the purpose of which is to intimidate and coerce individuals and societies.

The financing of terrorism will in turn refer to any form of financial support to acts of terrorism as defined in the previous sentence. Prior to the September 11, 2001 terrorist attacks on the United States, the United Nations (UN) had made numerous attempts to fight terrorism and its financing, in the form of international treaties. For example, Article 2 of The International Convention for the Suppression of the Financing of Terrorism (1999) states that:

> "Any person commits an offence within the meaning of this Convention if that person by any means, directly or indirectly, unlawfully and will fully, provides or collects funds with the intention that they should be used or in the knowledge that they are to be used, in full or in part, in order to carry out:
>
> (a) An act which constitutes an offence within the scope of and as defined in one of the treaties listed in the annex; or
>
> (b) Any other act intended to cause death or serious bodily injury to a civilian, or to any other person not taking an active part in the hostilities in a situation of armed conflict, when the purpose of such act, by its nature or context, is to intimidate a population, or to compel a government or an international organization to do or to abstain from doing any act."[4]

The problem with Conventions such as the one described above is the fact that, in practice, it is difficult for countries to adapt their existing legal and regulatory structures to meet the requirements of the Conventions, making their signing and ratification a symbolic (as opposed to concrete) gesture. This is an issue that we will return to later on. A few days after the attacks, the Security Council of the UN adopted Resolution 1373 to restrict the financing of terrorist activities, and a Special Committee was established to oversee the compliance of countries with provisions contained in the Resolution.

The problem with UN Conventions is that it is difficult for countries to adapt their existing legal and regulatory structure to meet the convention's requirements

Since the 9/11 attacks, the Financial Action Task Force (FATF), an intergovernmental organization, has also taken a lead role in the fight against terrorism financing[5]. The establishment of the FATF at the G-7 Summit in Paris in 1989 to combat money-laundering was in response to mounting concerns over declining taxation revenues as funds are moved to tax-havens or underground, and a recognition that large amounts of money, a significant portion of which resulting from drug crimes, were being laundered (the International Monetary Fund [IMF] estimates that money-laundering amounts to 2-5 percent of global GDP[6], which could translate into more than $1.5 trillion dollars yearly).

The FATF is currently made up of thirty-one countries (including Canada) and two regional organizations (the European Commission and the Gulf Co-operation Council), and it issued forty Recommendations on money-laundering in 1990 (which were revised in 1996) to cover all the relevant aspects of the fight against money-laundering, and which all countries are encouraged to adopt. These Recommendations, even though not legally binding upon countries, are now considered to be the international standard to deal

with money-laundering. The FATF extended its mandate to combat terrorist financing by issuing eight Special Recommendations on October 2001; a ninth Special Recommendation was added in October 2004.

The special recommendations call on countries to ratify and implement UN instruments against terrorism financing, criminalize terrorism financing and money-laundering, freeze and confiscate terrorist assets, report suspicious transactions related to terrorism, cooperate with other countries in the fight against terrorism, regulate informal value transfer systems (IVTS) or alternative remittance systems, keep more detailed records for wire transfers, review laws and regulations for entities (especially non-profit organizations) that may be abused for terrorism financing, and have measures in place to identify and deal with cash couriers[7]. While there are some similarities between the recommendations and UN resolutions, the focus on alternative remittance systems and wire transfers was new. The FATF also put forward an action plan that required its members to conduct a self-assessment exercise by the end of 2001 and provided additional guidance to help financial institutions in the detection of terrorist financing; it also called for regular publication of frozen terrorist assets and provision of technical assistance to non-FATF members[8].

The FATF works in close cooperation with other important international organizations such as the IMF, the World Bank and the UN. The IMF and the World Bank launched the Financial Sector Assessment Program (FSAP) in 1999, and the IMF, with its almost universal membership, contributes to international efforts to fight against money-laundering and terrorism financing by sharing information, providing technical assistance in the financial sector, and (since March 2004), making anti-money-laundering and combating the financing of terrorism (AML/CFT) assessments a regular part of their work, where compliance with the FATF recommendations (40+9) is verified.

Another important actor is the Egmont Group[9], which was established in 1995 as an informal gathering of Financial Intelligence Units (FIUs), which are national agencies that collect information on suspicious or unusual activity, analyze and disseminate the data to national authorities to combat money-laundering and terrorist financing. The FATF is to be credited for the creation of national FIUs, and regional-type FATF bodies such as the Middle East and North Africa (MENA) FATF. The Egmont group meets once a year, and its main goal is to promote international co-operation between FIUs in sharing information that can be important for investigative purposes. In Canada, the relevant FIU is the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) and it was created in July 2000 under *The Proceeds of Crime (Money-laundering) Act*[10]. There are currently 101 countries with recognized FIUs and once again, it is important to keep in mind that FIUs were originally created to deal with money-laundering and other financial crimes.

While the list of actors that I have just described is not exhaustive, the point that needs to be made is that many of the national, regional and international efforts that are taking place to fight the financing of terrorism may not necessarily be complementing each other, given that they are conducted independently (despite information sharing in some cases); at worse, some of the initiatives may be undermining each other, and maybe the time has come to create a "World Anti-Terrorism Organization" (WATO) whose primary objective will be to fight terrorist financing by supporting and coordinating the different efforts that are being made by the UN, FATF, the Egmont Group, the IMF, and FIUs.

Fraudulent Acquisition of Funds

While it is clear from the previous section that much of the current effort to combat the financing of terrorism derives its origins from anti-money-laundering efforts, it is important to distinguish money-laundering from terrorist financing. A recent article in The Economist concluded by saying "There is no great risk in scrapping the specific rules related to terrorist finance. Much information will still be captured, because parallel efforts to combat money-laundering will continue (and are anyway more effective)"[11] – creating the impression that terrorist financing and money-laundering are the same. While there are similarities between money-laundering and terrorist financing, there are also differences.

It is important to distinguish money-laundering from terrorist financing

Terrorism is typically driven by ideological, religious or political motives, whereas organized crime (and the associated money-laundering) is driven by profit. To the extent that funds for terrorist financing are derived from illegal sources (for example, drug trafficking or illegal arms trade) and that terrorists engage in conventional money-laundering to move funds around to support their activities, the same techniques used to combat the financing of organized crime can be used in combating the financing of terrorism. However, some of the money used for terrorist activities originates from legitimate sources. For instance, terrorist organizations are sometimes engaged in legitimate business undertakings in order to raise funds, or they may also obtain money from legitimate sources such as private donations or charitable contributions, making anti-money-laundering legislation moot, as the latter assumes that the funds in question are illicit.

The issue gets even more complicated when states sponsor terrorist activity by providing not only financial support, but also training and logistics. Furthermore, terrorist operations may require relatively little money (for example, it is believed that the attacks on the World Trade Center and the Pentagon cost half a million dollars), which means that it may be relatively easy to conceal, compared to conventional money-laundering.

The similarities and differences can be further understood by looking at the processes of money-laundering and financing of terrorism. Money-laundering is a process whereby the illicit proceeds of crime are hidden or transformed so that they can be used or re-invested into a criminal organization. The process consists of different stages – placement, layering and integration[12]. In the placement stage, illegal proceeds are deposited into the financial system, usually a financial institution, such as depositing cash into a bank account. The layering stage involves separating the deposits by repetitive and complex transactions, and moving the funds to other institutions to obscure their origins. Finally, the integration stage involves the return of funds to the legitimate economy by buying assets or to finance new criminal enterprises. Most anti-money-laundering techniques attempt to identify laundered funds at the placement stage; for instance, banks are required to report abnormal or suspicious transactions.

The financing of terrorism also involves money-laundering in the form of placement, layering and integration, to allow the funds to be used without attracting the attention of law enforcement officials. The difference, however, is that the placement stage, as explained earlier, may consist of legitimate or criminal proceeds, and the integration stage consists of funding terrorist activities, with deadlier ramifications. A final difference pointed out by Gillespie (2002), with interesting policy implications, is that terrorist assets will usually enter the financial system abroad, especially in jurisdictions where regulations are light[13]. Traditional anti-money-laundering initiatives that focus on the placement stage may thus be useless. Instead, what is required is the identification of recipients at the integration stage, and then working backwards to locate the donor. This reinforces the point that was made at the beginning of this paper, namely that the information contained in money flows is more important than the money flows themselves.

Even though one would expect that most money-laundering by terrorists takes place through the formal banking system (for example through wire transfers) because of the latter's international reach, and especially where regulations are not properly enforced, other methods of moving funds to finance terrorism include informal value-transfer systems (IVTS), commonly known as *Hawalas*; trade-based money-laundering; and cash couriers[14]. *Hawala* is an ancient banking system that originated in the Middle East and South Asia, and is not well known outside the communities that use it. Due to international migration, and the use of the internet, its use has spread around the world, and it has become faster and more effective. It is popular in the Middle East, Asia, and among immigrant communities in the Western world.

Hawala transfers money from one country to another without actually moving it, and the system is based on trust, to move funds and settle accounts with almost no paper trail. The transfer takes place as follows. Person A from country X wants to send money to person B in country Y.

Person A gives the money to a broker *(Hawaladar)* in country X, who charges her a relatively low fee together with a more favorable exchange rate than what is offered by the bank. The broker then contacts another broker in country Y by phone, fax or email, who gives the money to person B based on a prearranged code word or number. To settle accounts with each other, the broker in country X can either reduce the debt owed by her to the broker in country Y, or else, expect a remittance from the latter. As regards trade-based money-laundering, it involves the trade of commodities (such as gold and diamonds), which are of high value and can be easily transported and sold for cash, and false invoicing to transfer funds.

Having identified some of the main ways by which sums can be transferred to finance terrorism[15], it is equally important to focus on the sources of the funds. Terrorist financing comes from two main sources: state entities and private revenue-generating activities[16]. Notable cases of state-sponsored terrorism include the involvement of Libya in the Lockerbie bombing, and the sanctuary provided by the Taliban regime in Afghanistan to Al Qaeda (although evidence indicates that the Taliban did not provide financial support), and this type of support has declined in recent years according to some experts, which may reflect a desire of states to escape international isolation[17]. Indeed, the Libyan government recently accepted responsibility for its involvement in the Lockerbie bombing and agreed to provide compensation to families of victims as long as the UN and the United States lifted economic sanctions against it.

Income from private revenue-generating activities may be classified as legal or illegal. Legitimate sources of financing include personal donations, profits from businesses and charitable organizations; criminal sources include the drug trade, smuggling of weapons and other goods, credit-card fraud, kidnapping and extortion[18]. It is difficult to determine the ratio of legal to illegal proceeds in the funding of terrorism, but the fact remains that funds raised from legitimate sources are harder to detect, especially when small amounts are involved and when the individuals or organizations involved have no prior record. FATF experts have identified legal sources in the form of: "collection of membership dues and/or subscriptions; sale of publications; speaking tours, cultural and social events; door-to-door solicitation within the community; appeals to wealthy members of the community; and donations of a portion of their personal earnings."[19]

The issue of donations and charities is important, especially in the Islamic world, where *zakat* (charity) is one of the five pillars of Islam. Rudner (2006) reports that "the largest single source of revenue is the diversion to militant organizations of the charitable contributions *(zakat)* which Islam enjoins the faithful to donate…"[20]. Thousands of Islamic banks around the world allocate funds to *zakat*, in accordance with the *sharia* (Islamic law) without being subject to any supervision, and these transactions go unrecorded and cannot be identified[21].

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Vulnerabilities of the Financial System

In this section, we consider the vulnerabilities of the financial system, which consists of both formal and informal institutions, and in particular, we consider the different ways through which terrorists are able to engage in money-laundering to finance terrorism.

Financial markets are characterized by asymmetric information, where one party to a transaction has more information than the other party. For instance, it is not uncommon for potential borrowers to know more about the risks and returns of a project than do lenders. This problem leads to moral hazard (where borrowers behave differently once they have acquired a loan) and adverse selection (where most borrowers are of the risky type), causing financial markets to fail to allocate resources efficiently. Asymmetric information increases the likelihood that terrorists will exploit the financial system; more precisely, lack of information may prevent banks from distinguishing legal from illegal proceeds, and they may unknowingly participate in money-laundering as a result.

In order to limit problems caused by asymmetric information, authorities (regulators) impose due diligence rules on banks, which thus become the agents of governments by providing relevant information. Obviously, left on their own, private banks have no incentive to look for this information since, once discovered, the information becomes a public good (an unregulated market will thus underprovide the optimal amount of information). When rules are imposed by authorities, banks will exert a certain level of effort that is dependent on the costs of the regulation (some or all of which can be passed on to consumers) and on the reputational costs of disseminating information about their clients. Information asymmetry between banks and authorities also makes the task of regulators difficult since they cannot perfectly monitor how much effort banks are making to identify suspicious behavior. Hence, in designing regulatory frameworks, authorities need to be aware of the incentives that agents face, and the factors that may lead them to behave sub-optimally.

As mentioned earlier, terrorists raise funds in countries that are different from those in which they plan to conduct their operations, and need to take advantage of weaker systems that can allow them to move funds across countries. A second source of vulnerability in the financial system is the existence of offshore financial centers (OFCs) with lax regulations, where there are greater risks that terrorism transactions can be hidden, and that facilitate the movement of funds across international borders. It is to be noted that these OFCs have also come under scrutiny as they represent a loss of tax revenue for countries around the world, as individuals and firms hide their income in these "tax havens". OFCs provide financial services (through banks and other agents) to non-residents, and are attractive to terrorists and criminals because of very low (or zero) taxation, light financial regulation, and banking secrecy and anonymity. Once again, asymmetric information characterizes

OFCs and can be exploited by terrorists to finance their activities. The same techniques that are used by conventional money launderers can be used by terrorists to exploit the laxity provided by OFCs.

Consider the following example. An offshore bank is set up as a shell bank (an institution with no real presence) by terrorists and does business with onshore banks through correspondent bank accounts (which allows a bank from one country to open an account with a bank from another country) in order to facilitate access to foreign currency and transfers of money, in other words, to infiltrate the banking system of the target country. Once the correspondent bank account is opened, the legitimate bank in the target country may not be able to trace the origins of the funds being transacted because of the lack of regulation of the shell bank. Sounds far-fetched? Not really. Offshore (or shell) banks have the ability to move "dirty money" in and out of other countries because of a lack of regulations. Individuals may also move their money offshore to "trusts" that are subject to strict privacy rules in order to protect it from local authorities.

The vulnerability of the financial system to terrorist financing is not limited to formal institutions but also to Informal Value Transfer Systems, or hawalas

Understanding why OFCs maintain lax regulations is important. Most OFCs are located in countries without an abundance of natural resources, and which lack the capacity to generate revenue from non-financial services; interestingly, a number of OFCs are located in small island developing states, which are known to be economically vulnerable. The benefits generated from offshore activities due to lax regulations by far outweigh the costs for these OFCs (since the impact of terrorist activity or organized crime will not be directly felt by them). Furthermore, international regulations to make the activities of OFCs more transparent are deficient, and considered an infringement on national sovereignty by these OFCs. Until the causes of lax regulations are properly addressed, they will remain an attractive destination for terrorism financing and money-laundering.

The vulnerability of the financial system to terrorist financing is not limited to formal institutions but also to IVTS (or *hawalas*) discussed earlier. In many parts of the developing world, financial systems are repressed: remittances are heavily taxed; foreign exchange transactions are restricted; and artificial interest ceilings lead to shortages so that banks have to ration the limited credit to investors. All these factors combine to make people turn to IVTS, and in some cases, this is the only option available to them. While it is possible for investigators to follow the bank records of *hawaladars* (since at some point the funds involved need to be converted) for instance, this requires an enormous amount of resources. Even though some countries have adopted laws that require *hawalas* to formally register and keep records (which is one of the nine Special Recommendations of the FATF), the policy will only work to the extent that *hawaladars* are willing to do so.

Some have argued that *hawalas* should be eliminated[22]. It is my view that this is not a viable strategy because it will push this system even more underground, and make suspicious activity harder to detect, as people respond

to the new conditions that they face and try to conceal this activity further, or resort to other illegal means (an analogy is a complete ban on child labor which led to child prostitution in some countries). More importantly, it might prevent funds intended for legitimate uses from reaching their targets, which can be a problem for recipients that depend on this source of income for a living and do not have access to alternative means. Instead, providing alternatives to IVTS may be more helpful than a complete ban and may make the system more competitive, and this is an important challenge for policy makers. In the long-term it may also be helpful to think of ways to make the formal financial system in certain parts of the world more attractive than *hawalas*, by liberalizing financial markets, lowering taxes on remittance flows that transact through the formal market, and removing restrictions on interest rates and foreign exchange flows.

Conclusions and Policy Implications

Since the September 11, 2001 attacks on the United States, an explicit objective of the war against terrorism has been the disruption of financial networks of terrorist organizations. Millions of dollars have been seized, charities supporting terrorist organizations have been closed, and assets frozen, but it is still difficult to judge whether the war on terrorism financing is being won. This paper recognizes that tracing and intercepting funds intended for terrorist activity is a difficult endeavor given the magnitude of capital flows, the interconnectedness of capital markets, and the relatively small amounts of money required to conduct deadly terrorist operations. However, analyzing the money trail can yield important intelligence, which can be used to disrupt terrorist activity.

This paper has analyzed the fraudulent acquisition of funds by terrorists and assessed some of the vulnerabilities of the financial system. It becomes clear from the analysis that banks and financial institutions need to have in place effective regulatory frameworks to detect and report suspicious transactions. While much has been accomplished in developed countries in this regard, developing countries with weak AML/CFT regimes need to receive technical and financial assistance from international organizations and bilateral donors, or they risk being excluded from financial markets. There is no reason, for example, why a proportion of foreign aid should not be devoted to upgrading AML/CFT regimes, and countries that comply with FATF standards might even be rewarded by donors (after all, the history of foreign aid is full of examples where countries were rewarded for security reasons during the Cold War).

Analyzing the money trail can yield important intelligence

Because of the information asymmetries discussed in the previous section, collection of relevant information is key. The optimal amount of information collected will be reached only when agents are provided with the right incentives to do so; this information must be easily obtainable and ready to be shared with intelligence agencies, and international cooperation is required

given the interconnectedness of global capital markets. The enforcement of FATF Special Recommendations across countries, and sanctioning countries in the case of non-compliance, will provide the necessary teeth to FATF recommendations and UN resolutions and conventions; increased monitoring and surveillance of OFCs is also required.

Our analysis in this paper has focused on the 'supply side', namely disrupting the supply of funds required to conduct terrorist operations. Simple microeconomics tells us that we should worry as much about demand as we do about supply: restricting supply of funds or demand for funds will both diminish terrorist activity. Our focus, therefore, should not be on money flows only, but also on the demand that drives the money flows. While it is beyond the limits of this paper to address the demand side, suffice it to say that the war against terrorism financing will only be won if the demand side is also considered. Indeed, to the extent that terrorism is a systemic response to political, economic and social problems, demand-side strategies need to address the root causes of these problems. The challenge is to ensure that the policies and regulations (or sanctions) implemented in the fight against terrorism do not hurt innocent people, and that they be mindful of the protection of civil liberties that democracies afford to their citizens. ◆

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