Luxembourg Institute for Global Financial Integrity

Global Financial Integrity

The Challenges Facing the Global Financial Sector, National Financial Centers and Jurisdictions

Within the global financial sector, ethics and Integrity are centered in corporate financial governance and market integrity of banks and other financial services. The present global financial crisis has shed light on certain aspects only of the issues of ethical conduct and integrity that originate from within the global financial sector, namely the willingness to engage in legitimate activities presenting excessive risks, rewards that promote the taking of such risks, lack of transparency and failure of responsibility and accountability in financial business management and oversight. The whole has been severely compounded by failings and shortfalls of those responsible for regulation, oversight and enforcement.

Admittedly, stakeholders in the exceptional financial gains generated, be them shareholders or originators of such gains in banking or other financial services amongst others, have found no qualms in accepting the financial benefits of the whole set of activities in question. The accumulation of wealth as an end in itself, devoid of ethical considerations, has been a major driving force. There has been no consideration given to the tradeoff between gain and ethical standards based on the principles of integrity, namely fairness, transparency, responsibility and accountability.

The only criminal issue brought to light and into focus in the context of the present global financial crisis is that of *tax evasion*, which is related to legal considerations of tax policies and practices of nations around the world. For banking and other financial services, and the national financial centers and jurisdictions in which the financial transactions take place, *client confidentiality* (or so-called bank secrecy) and *exchange of information* between nations have been the sole matters subject to scrutiny and vowed public actions.

The G20 and the OECD’s Global Tax Forum pertaining to transparency and exchange of information are at the forefront of concerted government activities to combat tax evasion and improve information exchanges between jurisdictions. *Money laundering* is broached only as the side effect of the financial “recycling” of ill-gotten gains from tax evasion.

The political focus on tax evasion and on so-called bank secrecy is obviously driven to no small degree by the practical matter of governments seeking increased revenues under the considerable pressures that have risen due to the exceptional increases in national public debts as a result of the dramatic jumps in national public expenditures to contain the global economic crisis and restore economic activity. Both global financial and economic crises, intertwined and inseparable, have brought in a new era of international financial cooperation with new and existing international agencies, being reorganized and equipped with new powers, to orchestrate increased global regulation, oversight and enforcement across national financial centers and jurisdictions. The World Bank, the International Monetary Fund, the OECD and the Financial Stability Board, to name but the most recognized bodies, are about to impact profoundly the global financial sector and its national financial centers and jurisdictions.

Money Laundering of Criminal and Corrupt Funds

Tax evasion with its related “recycling” of such ill-gained funds through money laundering activities are but one source of criminal funds entering the global financial sector. Other criminal activities, such as organized crime, serious crimes and fraud within and outside the global financial sector, are considerably bigger sources of funds subject to money laundering.

In addition to criminal funds entering money laundering, corruption is the other source of ill-gotten funds washed through financial and non-financial transactions. Corruption here pertains to bribe money received by public officials or private parties in facilitating business transactions and/or official authorizations. It as importantly pertains to the funds originating from personal enrichment of heads of state, their family members and relatives and close relations, and of national bureaucracies through the looting of national coffers and natural resources.

The basic dilemma in the combat against corruption for the global financial sector is that corruption per se needs to be recognized in national legislations as illegal and a crime for banks and other financial services to be able to respond appropriately within the context of national regulation, oversight and enforcement and under the auspices of international agencies, like the network of national *Financial Intelligence Units* organized under the *Egmont Group*, *Moneyval (*Council of Europe*)* and the *Financial Action Task Force* on money laundering and the combat against organized crime and the funding of terrorism (FAFT-GAFI).

Corruption sanctioned by law pertains essentially to bribery and has led to international cooperation as personified by the OECD Working Group on Bribery and Corruption. State corruption, a product of the so-called “kleptocracy”, is typically non-sanctioned by government within the country of origin and tolerated in countries where the funds are ultimately deposited and used. Even in the case of bribery, governments have been known to refrain from enforcement of existing laws under the guise that it would be contrary to national interests.

For banks and other financial services, the combat against corruption and the ensuing money laundering pose numerous and complex issues that often fall within the domain of corporate social responsibility. Some private banks and financial trade associations have constituted bodies, like the *Wolfsberg Group*, that have issued anti-money laundering (AML) principles to provide global guidance on sound business practices.

Responses of banks and other financial services are essentially voluntary and private initiatives. This has led nongovernment organizations, in particular *Transparency International* and *Global Witness*, to scrutinize the global financial sector’s behavior in the context of their efforts on combating corruption in its multiple forms. The record on the whole is rather poor, and additionally reflected in country assessments on money laundering in the combat against crime, terrorism and corruption made by FAFT-GAFI, Moneyval and other international bodies.

The global financial sector has essentially been found to be more concerned about reputation and reputational risk than about ethical business practices and the respect of the principles of integrity. Here, compliance tends to be limited at best to the strict application of the law, its rules and regulations. Customer due diligence, the so-called know-your-customer or KYC, suffers accordingly in regard to the combat against corruption in both that sanctioned and unsanctioned by law.

Funding of Bribery, Terrorism and Organized Crime

Efforts to combat the funding of bribery, terrorism and organized crime are intimately linked to those pertaining to money laundering. The same national and international agencies are typically involved in both. National law enforcement and intelligence agencies play here too the critical roles of identifying and investigating both the sources of funds and their uses.

The contributions of banks and other financial services are through collaboration to investigations and filing suspicious persons and transactions reports with the appropriate authorities within their national financial centers and jurisdictions. Here too, the global financial sector is found lacking in its willingness to provide information and to flag customers and their transactions. There is no doubt that at the funding end, banks and other financial services are dealing with "clean money" that may result from the product of either legitimate economic activity or laundered "dirty" money.

The issue remains here too of the efficiency and effectiveness of customer due diligence or KYC. It cannot be dissociated from the matter of client privacy, whether or not the banks and financial services are subject to bank secrecy laws in the national financial centers or jurisdictions where the transactions occur. Whether or not banks and other financial services are questioned as to the validity of their compliance guidelines and willingness to exchange information on a voluntary basis, the organizations in question undergo serious stresses in assessing whether or not a client is himself questionable or dealing in questionable transactions.

Corporate Financial Governance and Market Integrity

The whole issue of ethical financial business behavior and integrity revolves around corporate financial governance and market integrity. The culture in which a bank or financial service operates may lend itself to corrupt practices as witnessed in Transparency International's *Global Corruption Barometer*, *Corruption Perceptions Index* or *Bribe Payers Index*. Additionally, and more importantly, the national financial center or jurisdiction may in fact not fully observe professional excellence, ethical business practices and the respect of the principles of integrity.

The *CFA Institute* has issued for 2009 its *Financial Market Integrity Index Surveys* for six countries or jurisdictions, namely: the United States, the United Kingdom, Canada, Switzerland, Japan, and Hong Kong. The surveys are based on responses from investment professionals inside and outside the financial market of each country or jurisdiction.

On the rating scale applied of 1 (not ethical at all) to 5 (very ethical) for ethical behavior of market participants and the effectiveness of market systems in ensuring market integrity, countries at best scored around or close to the minimum of 3 in the 3 range for "somewhat ethical", with the United States perceived well within the 2 range of "slightly ethical".

In other words, not withstanding the US scores that indicate that the United States is soundly "slightly ethical" in regard to ethical behavior in the market and effectiveness of its market system for market integrity, the scores would infer on average that financial centers and jurisdictions around the world would be located on the border line of all being between "slightly ethical" and "somewhat ethical". These results again are based on investment professionals operating in the global financial sector.

2009 Financial Market Integrity Index Survey		
Country or Jurisdiction	Inside Market	Outside Market
United States	2.8	2.5
Canada	3.1	3.3
United Kingdom	2.8	3.0
Switzerland	3.2	3.2
Japan	3.1	3.0
Hong Kong	3.0	2.9
The CFA Institute, 2009		

The results of the CFA Institute Survey strongly indicate that banks and other financial services worldwide are in highly significant need of improving their ethical business practices based on the principles of integrity. The results further indicate that the regulatory and oversight environment is lacking in providing a market system fully conducive to market integrity.

Changes in financial behavior and business practices are tied to the three core functions of corporate financial governance, namely audit and internal control, compliance and risk management. The three functions in question need to address together the establishing of ethical standards and practices that apply to both internal operations and business activities. An organization's corporate governance charter must indubitably reflect the standards and practices in question in regard to the organization's best interests as well as the general interests of its stakeholders, be them owners or shareholders, employees, suppliers of financial services and products or clients.

Such ethical standards and practices require being embedded in a bank's or other financial services enterprise's compliance and in the procedures, processes and systems by which the enterprise operates. In turn, this will provide audit and internal control with the means to monitor internal and external activities of the organization. Audit and internal control will thus constitute a reporting system for both compliance and risk management, which are in turn primary information sources to the system as a whole.

In the changing landscape of the global financial sector, national financial centers and jurisdictions, emphasis must inexorably be increasingly placed on professional excellence, ethics and integrity. The issue facing the global financial sector and its activities within individual countries around the world is whether it becomes proactive and changes from within or is subject to increasing regulation, oversight and enforcement that involves growing international cooperation and coordination coupled with punitive measures and is geared to shape financial behavior and the avoidance of systemic risk.

Luxembourg Institute for
Global Financial Integrity

The Complex World of Financial Integrity facing the Global Financial Sector