
LKI Explainers examine an aspect of Sri Lanka's international relations.

Understanding the Risks of Money Laundering in Sri Lanka

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Abbreviations

| | |
|------|--|
| AML | Anti-Money Laundering |
| CFT | Countering the Financing of Terrorism |
| FIU | Financial Intelligence Unit |
| FATF | Financial Action Task Force |
| GDP | Gross Domestic Product |
| KYC | Know Your Customer |
| CDD | Customer due Diligence |
| DFS | Department of Financial Services |
| LEA | Law Enforcement Agencies |
| APG | Asia Pacific Group on Money Laundering |

In light of Sri Lanka's inclusion in the European Union's (EU) list of high-risk countries for money laundering, and the subsequent rejection of this list by the European Council last week, this LKI Explainer examines the key aspects of money laundering, the emerging challenges and its impact in Sri Lanka. It also explores vital domestic and international legal instruments in force to combat money laundering.

1. Introduction

The EU blacklist of countries with deficient anti-money laundering (AML) and counter-terrorist financing (CTF) frameworks, which included Sri Lanka, was unanimously rejected by the European Council last week.¹ The European Commission will now have to propose a new draft list of high-risk third countries that will address the concerns of the EU member states.

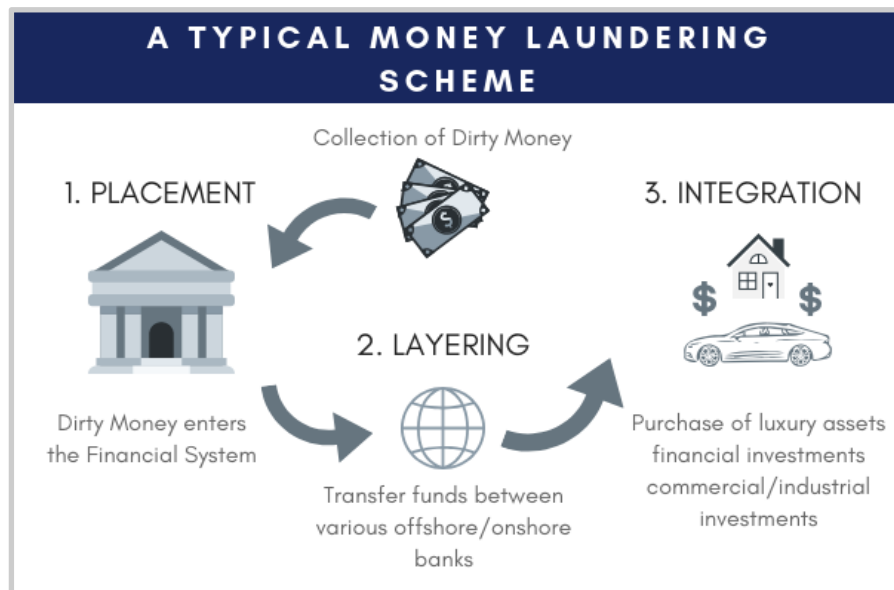
In 2018, the European Commission listed Sri Lanka as a country with deficient AML and CTF frameworks. Subject to a new methodology² which reflected the stricter criteria of the 5th Anti-Money Laundering Directive (Directive (EU) 2018/843), the European Commission re-published their list in February 2019, including Sri Lanka as one of the 23 countries with strategic deficiencies in their anti-money laundering and terrorist financing regimes that pose significant threats to the financial system of the EU.³ While the rejection of the list may be of temporary relief to Sri Lanka, it certainly does not absolve Sri Lanka of the incumbent responsibility to strengthen its AML and CTF frameworks in compliance with international standards and requirements.

In light of these developments it is essential to understand the key aspects of money laundering and its implications for Sri Lanka as an emerging financial hub of the region.

1. What is money laundering?

- Money laundering is a process by which unlawfully acquired proceeds are made to appear to have been derived from a legitimate source.⁴
- Money laundering follows a three-stage process that involves transferring the cash acquired from illegal activities into financial institutions, obliterating the trail and the origin of the funds, and finally, reintroducing the money back into the legitimate economy, creating an impression of legitimacy.

Figure 1: The Process of Money Laundering



Source: Fuzzy Logix

2. How does money laundering impact society?

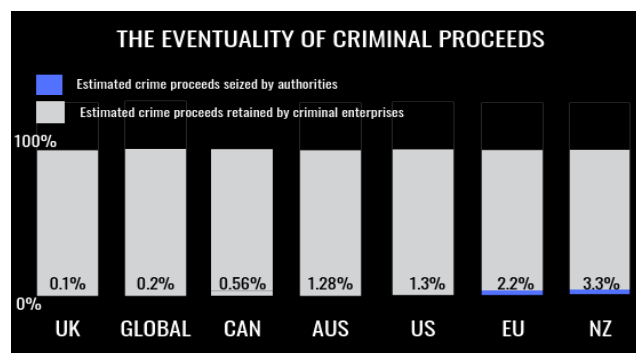
- Money laundering is intrinsically interwoven with criminal activity. Thus, it allows criminals to expand their operations with the accumulated laundered wealth, sourcing further financial activity.
- It provides corrupt public officials and individuals a method of concealing wealth acquired through unlawful activities such as extortion, kick-backs, bribes or misappropriation of public funds.⁵
- Money launderers often use front companies, to commingle the proceeds of unlawful activity with legitimate funds. These can result in the crowding out of private sector business by criminal organisations.
- Money laundering can potentially shift the centre of the economic power to criminal organisations. Power thus accrued can have a corrupting effect on all levels of the society and effectively weaken the social fabric and ultimately the democratic institutions of a state. This would inevitably lead to a serious erosion of the rule of law.
- It can also distort the true economic state of a country.
- Money laundering is a primary method by which terrorist organisations fund their activities.⁶

- Licensed financial institutions are frequently used in money laundering. The more laundered money that runs through these institutions, the more volatile they become. This volatility can threaten the *bona fide* investors.
- The United Nations Office on Drugs and Crime (UNODC) estimated that approximately USD 1.6 trillion, that is 2.7% of global GDP was laundered in 2009.⁷

3. What are the problems in combating money laundering?

- The increasing methods and sophistication of money laundering provide countries with a complex and dynamic challenge.
- With the growing complexities of the *e*-transaction systems and the increasing number of transnational transactions, banks and financial institutions can find it difficult to manage cross-border and multi-jurisdictional anti-money laundering compliance requirements.⁸
- A key issue is the lack of capacity to investigate and keeping personnel informed of the changes in the regulatory requirements and rapidly evolving technologies used in money laundering.
- The ‘interception rate’ for money-laundering at the global level remains very low. Less than 1% of the proceeds of crime, laundered via the financial system are seized and frozen.⁹

Figure 2: The Eventuality of Criminal Proceeds



Source: *The Inquiring Mind*, 2019

- The key responsibilities of financial and non-bank institutions regards ‘Know Your Customer’ (KYC) and Customer Due Diligence (CDD) rules, which makes it incumbent on these entities to ensure that they have all the information on their customers, before they enter into a financial transaction with them and that ensuing transactions are in conformity with the information that is available.

- These entities have the obligation to prove that they acted in probity on the basis of the information collected and in conformity with the KYC and CDD rules applicable to these transactions.
- Financial institutions act as the first line of defence against money laundering, and recent cases highlight the difficulties that arise for authorities to police the wave of cash that is washed through the banking system.¹⁰

4. Some examples of the most high-profile money laundering cases

- In 1998, Russian criminals laundered an estimated USD 89.1 billion [conversion done using year average of 1998] through shell banks in Nauru. They were able to do this because Nauru reportedly allowed its banks to function without verifying the identities of its customers or questioning where deposited money came from.¹¹ Consequently, Nauru is included in the Financial Action Task Force's (FATF) blacklist of countries, occupying a high risk for international financial transactions.
- In 2012, Standard Chartered Bank in the United Kingdom was accused by New York's Department of Financial Services (DFS), for helping the Iranian government to circumvent US money laundering regulations to the tune of an estimated USD 191.8 billion over 10 years.¹²
- President Ferdinand Marcos channelled a purported fortune of USD 10 billion into various offshore bank accounts, foundations and valuable assets making it difficult to be identified and located. To date, approximately only USD 4 billion has been accounted for.¹³

5. Combating money laundering in Sri Lanka

- Anti-money laundering policies refer to all regulations and laws that mandate financial institutions to proactively monitor their clients in order to prevent money laundering and corruption.¹⁴
- The Sri Lankan Parliament has enacted three acts to combat money laundering:
 - Prevention of Money Laundering Act No. 5 of 2006
 - The Financial Transaction Reporting Act No. 6 of 2006
 - The Convention on the Suppression of Terrorist Financing Act, No. 25 of 2005 (CSTFA)

5.1. Prevention of Money Laundering Act No. 5 of 2006

- The Money Laundering Act was passed prohibit money laundering in Sri Lanka and to provide necessary measures to combat and prevent money laundering.

- The Act defines money laundering as “engaging directly or indirectly, in any transaction in relation to any property which is derived or realized directly or indirectly, from any unlawful activity or from the proceeds of any unlawful activity.”¹⁵
- The Act further criminalizes “receiving, possessing, concealing disposing of, bringing into Sri Lanka, transferring out of Sri Lanka, or investing in Sri Lanka, any property which is derived or realized, directly or indirectly, from any unlawful activity or from the proceeds of any unlawful activity.”¹⁶

5.2. The Financial Transaction Reporting Act No. 6 of 2006

- The Act established the Financial Intelligence Unit (FIU), an independent institution within the Central Bank of Sri Lanka and acts as the National Agency to collect information relating to suspicious financial transactions. This facilitates the prevention, detection, investigation and prosecution of the offence of money laundering.
- Through guidelines issued by the FIU, all financial institutions are required to maintain records of transactions and of correspondence relating to transactions for a period of six years from the date of transaction.¹⁷
- Financial institutions are required to report any transaction exceeding Sri Lankan Rupees 1,000,000 to the FIU.¹⁸
- The Director of the FIU reports to the Governor of the Central Bank through an Assistant Governor with regard to its general administrative functions. However, suspicious transactions reported to the FIU are handled independently by the FIU together with the law enforcement agencies (LEAs).

6. Why is it important for Sri Lanka?

- With the tighter anti-money laundering regulations in the US and Europe, criminals are moving their money laundering activity into countries with lax regulations to avoid detection. This puts pressure on regional financial investigation units, financial institutions and associated stakeholders to improve their anti-money laundering (AML) practices.
- Sri Lanka is on the European Commission’s blacklist of countries at risk of money laundering.¹⁹
- Although Sri Lanka is not a leading regional financial hub at the moment, with the upcoming Port City and the Government’s ambition to make Sri Lanka a global financial centre, it remains vulnerable to money laundering and financing terrorism.²⁰

- Financial Action Task Force (FATF) added Sri Lanka to its Public Statement entitled “Improving Global AML/CFT Compliance: On-going process,” also known as the “grey list.”²¹
- Therefore, Sri Lanka is required to implement an action plan to address several vulnerabilities, including improving mutual legal assistance, issuing customer due diligence rules for designated non-financial businesses and persons, and enhancing risk-based supervision which are the key gaps identified for immediate compliance.²²

7. What are the global initiatives and has Sri Lanka met the global standards?

- Sri Lanka is a member of the Asia Pacific Group (APG) on Money Laundering, a FATF-style regional body.
- Sri Lanka’s FIU is a member of the Egmont Group of FIUs.
- The global standards for AML are based on the recommendations by the FATF, which is the global regulator.²³
- The FATF recommendations set out the essential measures that countries should have in place to:²⁴
 - identify the AML/CFT risks, and develop policies and strengthen domestic coordination;
 - pursue money laundering and terrorism financing;
 - apply and ensure preventive measures for the financial sector and other designated sectors;
 - establish powers and responsibilities for the competent authorities (e.g., investigative, law enforcement and supervisory authorities) and other institutional measures; and
 - enhance the transparency and availability of beneficial ownership information of legal persons and arrangements; and facilitate international cooperation.
- In accordance with the requirements of the FATF recommendations, Sri Lanka has signed and ratified all important international agreements, namely the Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances,²⁵ United Nations Convention Against Convention Transnational Organized Crime,²⁶ the United Nations Convention Against Corruption²⁷ and the Convention for the Suppression of the Financing of Terrorism.²⁸
- FAFT requires countries to rapidly, constructively and effectively provide the widest possible range of mutual legal assistance in relation to money laundering, associated

predicate offences and terrorist financing investigations, prosecutions, and possible extraditions.²⁹

- The various international agreements entered into by Sri Lanka and the domestic legal instruments such as the Money Laundering Act and Financial Transaction Reporting Act provide a sound legal basis for assistance and, where required, extradition.

8. Conclusion

- Sri Lanka is a member of various regional and international bodies fighting money laundering. Additionally, Sri Lanka has passed numerous legislations to comply with the international requirements and standards.
- However, gaps exist within the legal framework of Sri Lanka. Notably, Sri Lanka lacks laws to monitor the financial activities of non-profit organisations, such as trusts and charities, some of which may be used as a front for money laundering. The FIU is in the process of strengthening the legal framework to effect the necessary legal provisions, in collaboration with the Attorney General's Department, to eliminate the gaps identified by the FATF and the APG.

9. Key Readings

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