This spring edition of the *Review of Financial Markets* (RoFM) features four contributions from specialists who straddle finance and academia — and the criminal world. A feature of the best business schools and universities in Britain and elsewhere is their close connection with the industries and professions they serve, to help share experiences and extend knowledge. Close cooperation between these groups generates insights and inspires ideas that modern financial businesses welcome. We hope this edition opens doors to some of that fresh thinking. There are no formulae in this issue; instead a deep dive into live, up-to-date research and data, and penetrating analysis, focused on practitioners’ interests and straddling our various professional areas – capital markets, financial planning, fintech and operations, risk and compliance, wealth management and of course integrity.

Dr Hatim El-Tahir of Deloitte and Henley Business School kicks off with a welcome to these events, which are linked in each case to our contributors, and an invitation to members at these events, which are closely involved for some years with, inter alia, the Cambridge International Symposium on Economic Crime. At a recent CPD event* (available on CISI TV) they made the point that “the recent conduct cost phenomenon draws out the need to think beyond the traditional notions of conduct risk management to take true account of the prudential and regulatory risk implications, while developing systems and controls that leverage risk management experience to inform and approve strategy, conduct and culture”. Failure to do so, they pointed out, raises both the conduct and regulatory risk inherent in operations, and as the Financial Conduct Authority (FCA) has noted: “Culture change within firms is essential if we are to restore trust and integrity to the financial sector, and the FCA will continue to focus on how firms are managed and structured so that every decision they make is in the best interest of their customers.”

This ‘recalibration’ of cultural and behavioural standards has seen banks espouse ‘values’ statements and engage conduct risk management professionals, who invariably cite the usual ‘best practice’. However, the senior management rhetoric is not translating into learned conduct risk management practice.

**Forthcoming research roundtables**

In March, the CISI will start a series of roundtables with major universities and business schools around Britain. These will provide an opportunity for members to delve into relevant research currently underway. The events will give researchers in these institutions the opportunity to meet their professional peers, to help shape their research and possibly gain access to unique data for mutual benefit. The first of these will be held in Scotland on 16 March 2016 at Strathclyde Business School and 17 March at University of Edinburgh Business School. The first London roundtable will be held at Cass Business School in April. We look forward to welcoming members at these events, which are linked in each case to our programme of integrity workshops for undergraduate and postgraduate students at these institutions. Full details on the CISI website events page.

Enjoy the issue, and please give us your feedback.

Guest Editor George Littlejohn MCSI, Senior Adviser to the CISI

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Daniel Broby, author of the third article, worked in the fund management industry for 30 years, holding a number of ‘C’ level positions at leading fund managers. His career involved working a number of different centres, including London, Copenhagen and Moscow, where he developed a strong focus on emerging markets. He is now Director of the Centre for Financial Regulation and Innovation at Strathclyde Business School in Glasgow. The crises of recent years, he points out, were in large part the result of regulatory failure to embrace the innovations that had evolved from academic research in finance. The regulatory responses to these market shocks, while in many cases welcome, were nonetheless based on scant research into the likely outcomes, particularly the impact on capital markets. That will be one of the chief focuses of the work of the Centre. It will be bringing empirical evaluation and robust testing to bear on the new regulatory models.

The final contribution is the result of a project incubated at the London School of Economics by Roger McCormick, a Visiting Professor at the School, and Chris Stears, Chartered MCSI, who have taken an ongoing analysis of the cost of conduct failures at big global banks to new heights – or depths. The numbers – see page 44 – are frightening. This duo know their stuff. Professor McCormick was formerly in the thick of City legal practice at Freshfields; Mr Stears, a lawyer and regulatory consultant, has been closely involved for some years with, inter alia, the Cambridge International Symposium on Economic Crime. At a recent CPD event* (available on CISI TV) they made the point that “the recent conduct cost phenomenon draws out the need to think beyond the traditional notions of conduct risk management to take true account of the prudential and regulatory risk implications, while developing systems and controls that leverage risk management experience to inform and approve strategy, conduct and culture”. Failure to do so, they pointed out, raises both the conduct and regulatory risk inherent in operations, and as the Financial Conduct Authority (FCA) has noted: “Culture change within firms is essential if we are to restore trust and integrity to the financial sector, and the FCA will continue to focus on how firms are managed and structured so that every decision they make is in the best interest of their customers.”

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*The cost of trust gone wrong – $300bn and counting*
CORPORATE SUKUK IN EUROPE: ALTERNATIVE FINANCING FOR INVESTMENT PROJECTS

Dr Hatim El-Tahir, Leader of Deloitte's Middle East Islamic Finance Knowledge Centre (IFKC), Manama, and Associate Professor of Finance at Henley Business School, Reading

heltahir@deloitte.com

INTRODUCTION BY GEORGE LITTLEJOHN MCSI

During 2015, Dr Hatim El-Tahir conducted a major global survey on the appetite for ‘euro sukuk’ amongst CISI members and others. His research partners, apart from the CISI, included Henley Business School, with which the Institute is engaged in a master’s programme on financial regulation with the UK’s Financial Conduct Authority, and the International Centre for Education in Islamic Finance (INCEIF).

The results were presented at a CISI event in London on 30 November 2015, featuring almost 30 speakers from the United States, Europe, the Middle East and Asia. INCEIF’s head, Daud Vicary Abdullah, for instance, flew from his headquarters in Kuala Lumpur to be with us. We are delighted to give this important research the airing it deserves. For full details of the research results and the project of which it forms part, please email Dr Hatim directly (details above).

EXECUTIVE SUMMARY

Industry policy makers and regulators continue to keep pace with global regulatory and financial markets development, providing the required support for the industry’s sustainable growth. The Islamic capital market is uniquely advantaged in the current climate to create innovative Sharia-compliant debt and equity instruments that will address the increased demand for funding infrastructure projects in both developing and maturing economies. Currently, developing countries spend about $1tn a year on infrastructure, and an additional $1–1.5tn will be needed through 2020 in areas such as water, power and transportation projects, according to the World Bank.

This industry study assesses the demand and supply – in European markets – for an alternative financing instrument that will stimulate economic growth and cross-border investment. There is arguably a reciprocal need of European corporates to finance infrastructure and investment projects, caused by scarce debt finance for long-term, generally high level of upfront capital infrastructure projects. There is also a need from Middle Eastern and Asian investors for Sharia-compliant assets in maturing economies that are often in time not economically correlated, eg, Europe.

The study provides empirical analysis of matching these two needs between historically interdependent trade and investment economies – the Middle East and Asia (MEA) and Europe.

THREE TRENDS EMERGING:

- Governments in several European jurisdictions are attempting to provide level playing fields for Islamic finance practice. Some have gone a long way, such as the UK, Luxembourg and Ireland. Others are striving to match regulatory developments in these countries and have provided good breakthroughs in changing national regulatory frameworks to host the industry, in particular, Turkey, Germany, Italy and possibly Spain, and to some degree France.

- Constrained professional and industry dialogue between corporate professionals and investment bankers, widening knowledge and awareness gaps of Islamic finance amongst the market players.

- The observational analysis enforces good market sentiment amongst practitioners and market players. The general perception is optimism for great growth in this market in the next few years, depending on global market conditions improvement.

THE SURVEY’S KEY FINDINGS REVEAL THAT:

- 91% of respondents have considered ethical investments in sukuk
- 68% of respondents would consider sukuk, and another 24% might consider the instrument depending on its merits if the transaction entailed any tax benefits
- The majority of respondents prefer equity followed by sukuk over all other proposed asset categories
- Stakeholders are more likely to dedicate a smaller percentage bracket of their capex to sukuk
- 81% of participants prefer to invest in USD-denominated sukuk
- 75% of respondents would still consider investing in sukuk even with lower/similar yields than other bonds
- 55% of respondents would definitely consider sukuk as a tool to reduce risk and diversify their portfolio, with another speculative 34%.

TAX, REGULATORY AND POLICY ENVIRONMENT – CROSS COUNTRY EXPERIENCES: FRANCE, GERMANY, THE UK AND TURKEY

The participation of each industry stakeholder plays a crucial role in developing an ecosystem required to build confidence in both potential sukuk issuers and investors. The study has found that the UK is leading the implementation of initiatives to encourage the growth of Islamic finance and the issuance of sukuk in the country.

The study looks at various indicators, such as social dynamics, an economic and regulatory review, and a participating stakeholder’s review to gauge the current climate and potential in moving forward.

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Conducive ecosystem rating:
SOCIAL DYNAMIC

The social fabric of different societies is gradually being redrawn with globalisation and the migration of people seeking better job prospects in developed nations. While Muslims constitute a minority group in France, Germany, and the UK, there is growing demand for Sharia-compliant goods and financial services, such as halal food and beverages, and investments in industries that are not related to gambling, alcohol, pornography, entertainment and pork.

TURKEY

With the majority of the population being Muslim, it was expected that the development of Islamic finance in Turkey would be largely driven by local demand. However, this was not the case given the sensitivities of developing the industry in the secular republic prior to 2012. The tide changed after 2012, when the Turkish Government introduced Islamic finance, through the issue of Turkey’s first sovereign sukuk.

FRANCE, GERMANY, AND THE UNITED KINGDOM

There are approximately four to five million Muslims residing in each of these three countries. This creates a reasonable mass for Islamic finance in areas of retail, corporate and the small and medium-sized enterprises (SME) landscape, all of which could help grow corporate sukuk issues in these countries.

THE MUSLIM POPULATION IN EUROPE

Key findings

While demography may determine the broad acceptance of Islamic finance within the country, it will not be the core determinant of interest by foreign investors in these countries. Luxembourg and Ireland are examples of European countries with similar demographics to France, Germany, and the UK, and these two countries have made progressive developments in the industry, with favourable banking regulations and government-initiated policies.

Countries that have a Muslim majority population (such as Turkey), may find that a Muslim majority could work as a double-edged sword as the general population leans towards secularism. This slows down progress in the development of Islamic finance.

ECONOMIC AND REGULATORY REVIEW

LEGAL FRAMEWORK

Establishing a comprehensive and effective legal framework secures the enforceability of Islamic finance contracts and ensures that there is an effective legal process for dispute resolution. Precedent sukuk default cases have highlighted disputes across different jurisdictions on the rights given to investors of special purpose vehicles (SPVs), a structure heavily utilised in Islamic finance contracts.

France

- Supervisory body: Autorité des marchés financiers (AMF)
- Legal framework was modified in 2009 to allow banks and private issuers to sell sukuk
- Clear guidelines for sukuk issuance, drafting sukuk prospectuses, and obtaining approval for listing on French regulated market
- Provision of advice to sukuk issuers throughout the listing process to ensure compliance with EU Prospectus Directive.
- Established co-operation with Accounting & Auditing Organisation for Islamic Financial Institutions (AAOIFI) to develop amendments to French law to accommodate Islamic finance.

Germany

- Supervisory body: Federal Financial Supervisory Authority (BaFin)
- There are clear guidelines on bank license
- Requirements for Islamic financial institutions under the German Banking Act
- Issued a banking license to a foreign bank (Kuveyt Türk Beteiligungsbank) to conduct limited Islamic banking operations in Germany
- Actively held conferences on Islamic finance since 2009.

Turkey

- Supervisory body: Capital Markets Board of Turkey (CMB)
- Legal framework was modified in 2013 to permit the use of diversified Islamic financial instruments in Turkey, enabling sukuk that are structured using Istisna’, Murabaha, Mudaraba, Musharaka, and Wakala
- Issued clear guidelines, principles, and legal framework for lease certificates (Ijarah), special purpose vehicles, and sukuk Ijarah.

UK

- Supervisory bodies: Financial Conduct Authority (FCA); Prudential Regulation Authority (PRA); the Bank of England, and the Government (HM Treasury)
- Legislative measures introduced to establish a level playing field for Islamic and conventional instruments and to enable UK companies to issue a range of Islamic financial products. Any inequality is swiftly remediated through revisions in the legislation and regulations.
Comparison with other European countries with established Sharia practices

Ireland
Supervisory body: Central Bank

- Established a Sharia Funds Specialist Unit to assist with regulatory applications involving Sharia funds
- Sharia element is viewed as a ‘socially responsible’ investment element
- Sharia-compliant funds domiciled in Ireland
- Accommodated within the existing tax framework
- Entitled to the same favourable tax treatment offered to conventional funds (such as zero tax on fund’s income or gains, no stamp duty, and zero withholding tax on distributions to non-Irish residents)
- Enjoy equal tax treatment for Islamic financial instruments and similar reporting obligations as conventional funds.

Ireland is home to two industries that are Sharia compliant and have the potential of boosting the sukuk liquidity pool

- Renewables and clean tech industry
  - Identified by the government as a key industry for development
  - Incentives for companies to realise inherent value from ‘carbon offset’ qualifying assets
- Aircraft leasing industry
  - One of the oldest and longest established international financial services industries in Ireland.

Luxembourg
Supervisory body: Commission de Surveillance du Secteur Financier (CSSF)

- Regulation issued in 2011 to clarify the tax rules and listing requirements for Islamic financial instruments
- There are no specific legal requirements concerning Sharia investment funds set up under the Luxembourg law
- Treatment of sukuk and remuneration of sukuk is similar to conventional debt and interest
- Payments on sukuk are not subject to withholding tax
- The direct and indirect tax authorities have also issued clarifications on the major principals of Islamic finance, direct tax treatment, and indirect tax treatment of Murabaha and Ijarah contracts.

Luxembourg has marketed itself not just as a prime location for setting up and servicing conventional funds, but also Islamic funds.

The Association of the Luxembourg Fund Industry and Luxembourg for Finance have put together brochures to provide comprehensive information on the legal framework and tax treatment for a range of commonly used Islamic finance structures, as well as best practice guidance for investors.

TAX NEUTRALITY

Amendments to tax laws, in order to establish tax neutrality for Islamic finance transactions and instruments, create a level playing field between conventional and Islamic financial products. Inequality of tax treatment arises in Islamic finance transactions due to a sale or exchange of the underlying asset to the SPVs, triggering capital gains, stamp duty, and withholding income taxes depending on where the asset owner is located in a foreign jurisdiction. Providing tax incentives could reduce the hidden costs of issuing sukuk and encourage more enterprises to issue or invest in them.

Analysed countries

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Key findings

Having the first mover advantage into the European sukuk market, the Saxony Anhalt (Germany) state’s sukuk issue in 2004 did not automatically translate into Germany becoming a leader in the European sukuk market. With no tax neutrality or favourable government policies subsequent to the maiden sukuk issue, corporate sukuk issuance is more concentrated on foreign companies that are keen on tapping into the deep liquidity in the German financial markets, rather than from local medium sized companies.

Developments appear more promising in France, the UK and Turkey, where there are regulations and infrastructures in place to promote the issuance of sukuk. However, guidance provided in Turkey is limited to sukuk based on Ijarah (lease certificates). Despite the limitations, the Turkish Government’s open support to develop the country’s Islamic finance sector and sovereign sukuk issuance serves as a promising factor.

OTHER PARTICIPATING STAKEHOLDERS REVIEW

Indirect policies

Implementation of policies to encourage the development of identified industry sectors, growth of local companies, or socially responsible investments can be strategic for the development of Islamic finance. The governments of France, the UK and Turkey have implemented several schemes which have synergies with the development of corporate sukuk.

Socially responsible investment (SRI) scheme

- The French Government’s active support for initiatives that develop social and environmental transparency of business
- Requirement for compulsory annual non-financial reporting on social, environmental and societal criteria for businesses whose shares are traded on a regulated market.
Given the parallels that can be drawn between SRI and Sharia-compliant products, France’s emphasis on SRI culture is strategic for potential growth of the sukuk market in France.

Examples of socially responsible investments include green bonds, which are debt instruments issued to raise financing for projects that generate direct environmental benefits (such as renewable energy, social housing, education).

**Green tax systems**

- France, Germany and the UK have in place green tax systems to encourage green innovation and achieve energy efficiency. The incentives to develop green innovation comes in various forms, such as:
  - Tax incentives, subsidies on research, and low interest loan programmes for energy efficient construction and retrofiting in Germany
  - Discounts on climate change levy and capital allowances on equipment to improve energy efficiency in the UK
  - Exemption from local property taxes for up to five years on green buildings in France. The development of green property is strategic for the development of Islamic finance as the underlying investments are also Sharia-compliant.
MONEY LAUNDERING – THE OFFENCE THAT DARE NOT SPEAK ITS NAME

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The views expressed are those of the author alone and should not be read as representing those of Police Scotland

INTRODUCTION

In the inaugural workshop of a series on the Proceeds of Crime Act (POCA) at Sussex University in October 2014, the National Co-ordinator of the Financial Investigation and Proceeds of Crime Portfolio for the Association of Chief Police Officers, Detective Superintendent Ian Davidson, commented that the text of the relevant proceeds of crime provisions didn’t actually use the words, ‘money’ and ‘laundering’, although they are used as a heading.1 He commented this was a good thing because the term ‘money laundering’ tended to evoke inappropriate images of cash in the British Virgin Islands or what happened on TV shows like The Sopranos.2

‘Money laundering’ has become a term of our age, a ‘must have’ inclusion in all descriptions of high powered economic crime and serious organised crime. But there is a considerable contrast between the extent to which people talk about money laundering and the incidence of high end criminals being prosecuted for it, except where the offences are essentially add-ons to other substantive charges. The money laundering offences set out in the UK legislation were designed to be effective stand-alone weapons against the practice in their own right, shed even of the obligations to define a predicate offence. But their use and application in criminal courts in that way has been muted, and the problem of high end money laundering is, if anything, even higher in the public consciousness than when the legislation was originally enacted.

In his recently published book Criminal Capital: How the Finance Industry Facilitates Crime,3 Stephen Platt is also critical of the ‘money laundering’ label, calling it “misleading”, and claiming “it has harmed efforts to prevent the activity it seeks to describe”.4 Platt considers the conventional three tier explanation of placement, layering and integration to be unhelpful too. Money laundering can occur without money being placed in a bank account and it isn’t necessarily an active process. It often involves “relatively passive financial arrangements not identified by financial institutions as suspicious because they do not have the characteristics of a ‘typical’ money laundering relationship”.5

The implication of these comments is that money laundering as an offence has an image problem. It is that somehow not holding its own; that even its very name could even be seen as a distraction from the business of recovering criminal assets.

A CRIME WITH AN IDENTITY CRISIS IS A NOVEL CONCEPT. WHAT IS THE PROBLEM?

There exists something of an orthodoxy within some criminology departments, if not elsewhere, which might be characterised as a sincere and deep rooted agnosticism as to whether money laundering should be an offence at all. “It could be argued that there already existed a criminal framework for prosecuting the underlying predicate offence that gives rise to the funds to be laundered”,4 offers a leading academic commentator on money laundering, Professor Jackie Harvey of Northumbria University.

What is implied here is that money laundering is not a proper stand-alone offence; it depends for its existence on other crimes and it is these underlying crimes that should remain the proper focus of law enforcement.

The impression that money laundering still has to justify itself as a crime at the existential level appears to be given support by the startling fact, pointed out by Mr Davidson in the same workshop presentation, that in its six years of existence, the Serious Organised Crime Agency (SOCA) did not record a single offence of money laundering.

One basic problem the crime of money laundering has is an apparent lack of congruence between how it is defined in UK legislation and how it is habitually referred to in the academic literature, where its meaning is continually rooted in the concept of ‘predicate offence’. The UK legislation is expressly framed in such a way that the principal money laundering offences are not directly linked to any predicate or specified offence.

Indeed the expectation of one authoritative commentator in the wake of the enactment of the Proceeds of Crime Act 2002 (POCA) was that the US imported concept of ‘predicate offence’ could “be consigned to the jurisprudential dustbin”.6

As concepts go, predicate offence has shown itself to be stubbornly persistent, however. This may be because the need to characterise the offence as essentially a derived offence is perhaps necessary, or at least helpful, to the subtext that says it really isn’t a proper offence at all. It therefore follows that the approach of UK legislation of stepping round the issue of predicate offence is not held up as a matter for approbation, but criticism, again by Professor Harvey, on the basis that “it is assumed (the author’s underline) that laundering can be regarded as an activity, discrete from any predicate offence”.7

According to Professor Harvey, there are consequences that follow from these issues of definition: “The definitions of the ‘headline’ laundering offences are so wide that almost any financial transaction is capable of being laundering if some of the money or other property has its provenance in crime.” And thereby the underlying purpose of the legislation, it is suggested, reveals itself: “By simply broadening the definition, the problem becomes bigger, attracting greater public attention … The result is that a rationale is supplied for yet further resources, such that the entire system becomes self-reinforcing.”8

Harvey quotes with approval the view of Rahn that this is an example of “the police creating increased demand for their activities by inventing new crimes”. In case of any residual doubt, Harvey asserts: “the existence of enforcement agencies, and indeed the creation of new ones, results in a self-reinforcing, self-perpetuating rationale and legitimacy.”9

2. Podcast from POCA workshop, October 2014.
6. Harvey ibid.
8. Ibid.
As already mentioned, a key feature of the UK money laundering provisions (POCA ss. 327–329) is that they do not require specification of any predicate offence. Money laundering is therefore an offence in its own right. What is required is evidence which shows that the money or property that is the object of the offending action is criminal property and that the offender knows it is criminal property. What this definition means and how it is applied has been the subject of significant recent case law which will be discussed later. The design of the legislation, however, appears to recognise that the essential purpose of money laundering is to obscure criminal origins – and that an offence that was dependent on exposing the specifics of those origins would not achieve what it was enacted to do.

The entry point for most money laundering investigations involving organised crime is not the predicate offence but typically a Suspicious Activity Report relating to a transfer of funds deemed by the reporting party to be 'suspicious'. This information has the status of non-disclosable intelligence, and it is obviously the business of law enforcement to translate intelligence into evidence.

### PROCEEDS OF CRIME

Proving the money is criminal by reference to the predicate offence would imply a retrospective trace of the funds to the criminal source. This is not a process that an organised crime group would typically find difficult to thwart. Indeed, a key characteristic of laundering schemes of any sophistication is the prevalence of suitable disconnects.³

A break in the trail can be arranged without too much difficulty, for example, through parallel loan arrangements. The suspicious fund transfers reported on the SAR may therefore trace to a legitimate source but actually offset the settling of a related debt arising from funds directly derived from a criminal source. They represent criminal funds, in other words, as opposed to being funds which are directly derived from criminality. Does this therefore provide an effective means of protection against the POCA money laundering provisions? It surely should not.

The prosecution needs to be in a position, as a minimum, to be able to produce sufficient circumstantial evidence or other evidence from which inferences can be drawn to the required criminal standard that the property in question has a criminal origin.⁴ It is perhaps unfortunate that this helpful statement of position is provided under the heading of ‘Proving that proceeds are the benefit from criminal conduct in money laundering prosecutions (proving the predicate offence);’ when really what it describes is how criminality can be proved without reference to a predicate offence. But this perhaps illustrates the very difficulties of perception as to what the crime of money laundering is that inhibits the ability to properly investigate it and prosecute it.

The ability to prove criminality through circumstantial evidence is also explicitly recognised in the relevant case law, specifically the case of R v Anwoir⁵ (the key findings of which were endorsed for Scottish purposes in the appeal hearing in HMA v Ahmed):⁶ ‘There are two ways in which the Crown can prove the property derives from crime, a) by showing that it derives from conduct of a specific kind or kinds and that conduct of that kind or kinds is unlawful, or b) by evidence of the circumstances in which the property is handled which are such as to give rise the irresistible inference that it can only be derived from crime.’

Even though the ‘irresistible inference’ test is now established, however, there is still ground to cover in terms of achieving a necessary consensus as to how the required standard of criminality can be proved. This is not an issue solely of how the legislation is interpreted, but also an issue of how the crime is typically committed by the organised crime groups posing the threats which, as Dr Peter Sproat, a lecturer in policing, points out, led to the enactment of the legislation in the first place.

The following is a real life example of a money laundering scheme where the identities have been fictionalised. The essence of the scheme was to use profits earned from drug trafficking by a Scottish Organised Crime Group (OCG) to secure the purchase of a local hotel. The method used to launder the money involved a labyrinth of corporates set up by another Scottish OCG to commit VAT fraud (of the type referred to as Missing Trader Intra Community Fraud – MTIC).

Essentially this was an instance of two OCGs teaming together on the basis of their distinctive capabilities. One generated income in Scotland that needed to be laundered; the other could launder it through a mechanism set up to execute MTIC fraud. The second OCG wanted to invest its criminal profits in Scottish property assets and the first OCG could help it do that by executing land purchases and securing through corrupt planning permissions, which would subsequently increase the value of those land assets.

Proving the overall scheme to a criminal standard of proof was obstructed by delays in obtaining international letters of request (ILORs) from Dubai and the hugely complex process of tracing the MTIC funds through to challenges undertaken that is heavily restrictive. The typical investigation entry point provides a natural focus on the characteristics of the transfer that caused the suspicions to arise in the first place. It was always understood that an inherent feature of the design of POCA was that it provided the means to construct a case whereby the requisite criminality, and the requisite criminal knowledge, could be obtained and proved by reference to circumstantial evidence relating to the manner and circumstances in which the money was treated.

The Crown Prosecution Service website sets out the position as follows:

> ‘Prosecutors are not required to prove that the property in question is the benefit of a particular or specific act of criminal conduct, as such an interpretation would restrict the operation of the legislation. The prosecution needs to be in a position, as a minimum, to be able to produce sufficient circumstantial evidence or other evidence from which inferences can be drawn to the required criminal standard that the property in question has a criminal origin.’

9. See Platt ibid.
criminal source (which was nevertheless achieved). There was also no substantive evidence which pointed to the Scottish drugs money being entered into the scheme (ie, the so-called ‘placement’ evidence).

In these circumstances, was it realistic, necessary or desirable to have to prove by reference to the whole scheme that the money was criminal, or should it not have been possible to prove the necessary criminality via irresistible inference from the available evidence of deceit? If there were parts of the scheme which could be evidenced to show deceit with the purpose of constructing false legends for the passage of monies, should that not have been sufficient to meet the necessary tests for the POCA money laundering charges?

The activity contained within the two boxes in the diagram above involved the creation of false invoices to enable related transfers of money: first from London to Dubai via Holland; secondly, from Dubai to Scotland, back to Dubai, via Holland to the Scottish solicitor who handled the settlement for purchase. The evidence of the deceit through the invoices was complete and beyond challenge.

In the context of an overall scheme where financial benefit can ultimately be traced to a number of individuals with criminal connections, should the existence of such compelling evidence of deceit within the two boxes provide sufficient evidence of criminality on their own?

In this case, it was the opinion of senior counsel that there was enough evidence to secure money laundering charges against the principals of the Scottish OCG – but only in the context of the whole scheme and ‘not overwhelmingly so.’ It was suggested the prospects of conviction might not outweigh the considerable financial risk of the case proceeding; advice which was taken by the lead prosecutor, being HMRC in London (the case ultimately became a joint enterprise between HMRC and the former Scottish Crime and Drug Enforcement Agency).

Experiences such as this obviously educate the prosecuting authorities, particularly in terms of key resource allocation decisions. But they also educate the launderers themselves as to the characteristics of money laundering schemes that are likely to prove resilient to prosecution.

The reality of modern money laundering is that arrangements are made precisely so there is no continuity of linkage between predicate crime and the visible channels used to launder the proceeds. Breaks will be engineered and other funds substituted to make sure that a classic ‘follow the money’ back to the crime investigation will meet a cul-de-sac in terms of an apparently genuine legitimate source, or an obscure labyrinth of interconnected transactions showing an ultimate source that is untraceable.

This essential characteristic of money laundering schemes is laid out in Platt’s recently published *Criminal Capital: How the Finance Industry Facilitates Crime*. Platt argues the ‘placement-layering-integration’ model of money laundering does not reflect its reality. His preference is for an ‘enable, distance and disguise’ model, which encompasses a wider range of facilitation and laundering conduct. Platt’s model is designed to assist banks become more effective in their AML procedures and suspicious activity screening. But it
Platt’s book includes a number of scenarios which purport to show how criminal finance operates in reality. They can be readily vouched as reflecting actual law enforcement experience. The real life example provided above mirrors the principle features of the Platt scenarios, including the use of pooled bank accounts, corporate service providers, and the exchanging and settling of debts using dirty cash such that it never needed to enter the banking system.

The simplified fictional scenario described in the diagram below is adapted from the shape of one of Platt’s scenarios (pp.79–83) to reflect actual experience of some of the mechanisms encountered from recent money laundering investigations.

The central figure in this arrangement is the central private banker, Edgar. He is a corporate services specialist who oversees a pooled bank account and a set of books. He also arranges for dirty cash pick-ups from Hector the night club owner, whose premises act as a drop venue for criminal funds. These funds do not touch any set of books except those kept by Edgar. Neither do they touch any bank account, for the cash that is collected by Edgar is used to settle debts owed to other subscribers to Edgar’s services. Note there is no line in the diagram that directly links the top half to the second half. The link is through Edgar. Needless to say the bank account is offshore and the location of the books is probably forth of the jurisdiction too. There aren’t going to be any SARS generated from any of this activity and the placement-layering-integration axis is irrelevant.

The essence of this scheme, and indeed any money laundering scheme above the most basic, is that disconnects are built into the arrangements as a fundamental feature so that there is no provable link between the money identified as suspicious and any predicate crime.

In his next article in the Review of Financial Markets, Kenneth Murray will consider whether POCA is up to the challenge of dealing with present-day crime; the $1tn role of trade-based money laundering; and ‘Project Jackal’; Scottish Police’s approach to translating a conceptual framework based on business strategy analysis to a practical programme capable of delivering tangible results in the public-private fight against money laundering and other economic crime.

1. Strathclyde Business School’s mission is to foster policy relevant research to support the practical application of innovation in finance. It aims to encourage regulatory principles, rules and guidance that are simple, understandable and clear. It supports regulatory requirements, oversight and intervention that reflect the nature, scale, sophistication and complexity of financial market participants.
effective at lobbying for their interests than investors or savers. This can distort markets. There is therefore a need to provide an independent and impartial advocate to promote the best interests of capital markets in the face of new financial innovation.

Clearly, the pace of change is fast. The crisis revealed many systemic problems arising from so-called shadow banking activities. Such ‘credit intermediation’ came from innovation. In effect, financial markets created entities and activities outside the regular banking system. This is another area of innovation that has to be addressed.

In the same vein, new and novel strategies are being devised. These come from new areas, such as behavioural finance and neuro economics. Regulators do not fully understand them but are responsible for their oversight. Systems, product design, investment process and measurement will all change. Even our very concept of risks (their proxies, variance and standard deviation) is being revisited.

Regulation should not just be about making law and enforcing it. It must also support trust and confidence. This is particularly true in the financial services sector and for its participants. Adoption of new rules and oversight should be done in conjunction with the development of a strong culture of ethics, a focus on clients and a respect for fiduciary interest. It should promote skills rather than just make boxes for people to tick.

Some may question whether academic research can fill the gap. Many practitioners complain about the assumptions academics make and on which financial models are built.

Let us not forget that academic theories have changed the world of finance. A large part of the world’s professionally managed money is indexed. The Arbitrage Pricing Theory gave birth to factor-based risk evaluation. The Black-Scholes options pricing model underpins the derivatives markets. Capital decisions, firm structure and the amount of leverage a firm takes on should optimally be based on theory. Thanks to academic models, it is generally agreed that there is a mathematical relationship between risk and return.

Practitioners argue that individuals are not rational, markets are not frictionless, information is not ubiquitous and data not normally distributed. They are to some extent right. Theoretical research does not take account of asymmetric information, trading costs, liquidity and tax. That said, it is robust and its conclusions are statistically based. Even so, research often pits academia against the world of active asset managers. This is because theoretical academics tend to be too dismissive of the persistence of risk-adjusted investment outperformance. It is a grey zone that needs to be more clearly delineated. Not everyone can be a passive participant in financial markets.

Despite all this, market efficiency is an important element in finance. Regulators need to worry about it because it is the backbone of finance. It provides the basis for price discovery and the continuous restructuring of the economy. Well-run markets support economic growth and facilitate capitalism. On a similar note, sound implementation of financial theory improves the efficiency of capital decisions, thereby favoring a better allocation of scarce economic resources.

Current issues, such as governance and internal corporate capital allocation, particularly in respect of pay and incentives, are even more immediate. The role of institutional investors is under scrutiny and regulators have taken note. Once again academia can step up to the plate. Research designed to improve institutional investor involvement and shareholder participation is needed. The billions of dollars of fines paid by the banks are testimony to the importance of getting governance right.

Academics can help policy makers, regulators, and finance industry professionals address the issues pertinent to financial regulation and innovation. They need to be the strategic link between policy makers, regulators and other financial industry participants. In this way, research insights into financial regulations, banking policies, risk management, investment benchmarks and corporate governance can be adopted by capital markets. This can be done with investigation and appropriate comment; especially on policy matters that relate to global financial markets in general and in the United Kingdom and the European Union in particular. After all, peer reviewed theoretical research drives both growth and innovation in the financial sector. It can assist government, regulators and industry. The aim should be use it to anticipate appropriate industry structures, governance and policy frameworks, regulatory systems, and responses.

In conclusion, with financial innovation happening at such a fast pace, there needs to be timely, economic, industry and social arguments for any change in regulatory oversight. There is a need for new rules, based on innovation that involves either leverage, derivatives or risk models. These must be developed with a better understanding of their impact. More effective capital markets and decision making is Pareto optimal for society.

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**WHAT CONCERNS US NOW?**

These pages display concerns about criminality, regulation and major fines (opposite). What worries global financial practitioners? One of the sharpest regular surveys for the past 20 years has been Banking Banana Skins from the Centre for the Study of Financial Innovation (CSFI), a London and New York-based think tank with which the CISI works closely. The latest survey, conducted in the final quarter of 2015, describes the risks currently facing the global banking industry, as seen by a wide range of bankers, banking regulators and close observers of the banking scene around the world. The survey received 672 responses from individuals in 52 countries, from the CSFI’s own contacts and those of PwC, the sponsors. The changing nature of risk was summed up by the sharp rise in concern about criminality, up from number 9 in the last survey to number 2 this time round, chiefly because of the alarming spread of cyber crime in an increasingly borderless market, particularly data theft. This, the survey points out, is closely related with technology risk (number 4) where underinvestment and obsolescence, and banks’ growing exposure to competition from ‘fintech’ companies, now present major challenges. One of the strongest risks is concern about the quality of banks’ risk management, which rose from number 11 in 2014 to number 6 in the latest survey. Although much work has been done by banks and their regulators to strengthen risk controls, there is a sense that banks have still not adequately addressed not just the scale of risk but also its changing nature.

“I am somewhat surprised,” says Dr Andrew Hilton, the Centre’s Director, “that concerns over regulation fell this year, albeit only to number 3 [from the top spot in 2014] when signs of regulatory ‘herding’ – a lack of diversity – abound and when banks face massive financial retribution for their post-2007/8 sins.” See next article.

But that’s what the banana skins survey is all about, he says:

You don’t have to agree – or to believe in the salience of the risk landscape exactly as painted by respondents. Rather, Banana Skins is intended to make the reader stop and think – and perhaps to adjust his or her behaviour accordingly. By itself, it won’t protect against a banking crisis, but it can – at least – provoke a discussion that might protect an individual institution from leaping over the cliff with the rest of the lemmings.

For details of Banking Banana Skins, and how to get a copy, see www.csfi.org

George Littlejohn MCSI
THE RISING TOLL OF CONDUCT COSTS ON GLOBAL BANKS

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It is not obtuse to suggest that following closely in the wake of the immediate ‘financial’ crisis was a crisis of ‘misconduct’ – some might argue that one, in fact, begot the other. And, despite being eight years on from ‘Lehman’ and the onset of the crises, organisations are still battling to regain the trust that was lost; trust that now largely centres on the ethical compass of individuals rather than the solvency of the organisation.

It is, of course, almost impossible to guarantee that people will behave in a certain way: an immutable consequence of one’s free will. A bank cannot reduce to zero the risk of a trader going rogue. But it can create an environment in which, you might say, ‘conduct/people risk’ is identified, measured, and actioned in the interests of stakeholders, whether that be the organisation’s clients, counterparties, employees, or the public at large. The essential question nevertheless remains: how do stakeholders test these more nebulous risk concepts when the traditional metrics for financial appraisal only tell half the story? A bank, whose business practices might be applauded on the basis of its financial performance in one year, might be harbouring an unidentified/unmitigated level of conduct risk that, if known, would question the bank’s sustainability and trustworthiness. You have to look ‘behind the balance sheet’ at reliable metrics for evaluating (and predicting) an organisation’s culture and conduct record.

This is what the Conduct Costs Project (the Project), sponsored by the CCP Research Foundation CIC, was set up to do. The Foundation, established in 2014, evolved from a project at the London School of Economics, where, in 2012, its Director, Roger McCormick, began exploring the impact that conduct and culture can have on long-term bank sustainability. Set in a certain way: an immutable consequence of one’s free will. A bank cannot reduce to zero the risk of a trader going rogue. But it can create an environment in which, you might say, ‘conduct/people risk’ is identified, measured, and actioned in the interests of stakeholders, whether that be the organisation’s clients, counterparties, employees, or the public at large.

The Project pioneered the utility, disclosure and reporting of conduct costs, as a highly objective indicator of the negative effect of ‘inappropriate culture’. The hypothesis is that the roll out of a unified system of conduct cost reporting across all financial services participants, worldwide, will over time demonstrate whether banks are in fact becoming more or less effective in changing culture and ushering in a new era of ethically appropriate behaviour and financial sustainability. If the current very high level of conduct costs is not reduced, and soon, it would take a brave man to argue that banks really have ‘turned the corner’. Even though certain banks may be able to easily afford multi-billion dollar fines, it would be a risky strategy to say to the public, in effect, ‘we know we’re bad but we can afford to be’. Some banks, however, may be more successful than others. So the need to have accurate figures on a per bank basis is crucial.

There is no generally accepted definition of conduct costs. The box below sets out the Project’s working definition. It is such that it ought to capture behaviour that impugns the integrity and good standing of the bank, on an objective basis. The scope of the definition is not limited to materiality (of whatever measure, be it balance sheet, bank reputation and sustainability or stakeholder sentiment), as all instances of misconduct should fall to account. Indeed, from a risk management standpoint, the bank ought to record, assess and ‘learn’ from all manner of misbehaviour, whether or not its consequence is financially material. Misconduct taken in isolation might be inconsequential. It may, however, indicate a trend – a pervasively operating misaligned incentive – that, if left unresolved or unmanaged, could lead to significant damage over time (to customers, shareholders, and the firm’s reputation).

What are conduct costs?

Conduct costs means all costs borne by a bank in connection with any of the following:

1. regulatory proceedings, specifically (but not exhaustively):
   a. fines or comparable financial penalties imposed on the bank by any regulator
   b. any sum paid to a regulator or at the direction of a regulator in settlement of proceedings of any kind
   c. any sum paid to, or set aside to be paid to, any third party or parties to the extent required by any regulator
   d. any sum paid, or set aside, for the purchase (or exchange) of securities or other assets to the extent required by a regulator and (if such information is available) to the extent such sum exceeds the open market value of such securities or other assets as at the date of purchase

2. any costs, losses or expenses which are directly related to an event or series of events or conduct or behaviour of the bank or a group of individuals employed by the bank for which any fine or comparable penalty has been imposed or any censure issued by a regulator

3. any sum that has become payable as a result of, or in connection with, any breach of any code of conduct or similar document entered into, or committed to, at the request of, or required to be entered into or committed to by, any regulator or any public, trade or professional body

4. any loss of income or other financial loss attributable to a requirement imposed by a regulator to place money on deposit with a central bank or other institution at below the market rate of interest, being a requirement imposed in connection with a breach of law or regulatory requirement

5. any sum paid in connection with any litigation (whether ordered to be paid by a court or tribunal or in settlement of proceedings) where the litigation involved allegations of material wrongdoing or misconduct by senior officers or employees of an institution which were not refuted

6. any other sum, cost or expense, not falling within any of (1) to (5) above that is paid pursuant to an order or requirement of a regulator and which is a result of any breach of any regulatory requirement or law.

Given the significance of conduct costs to culture, to regulatory and public perception of conduct generally, and to conduct risk management, we might reasonably expect banks to be keen to report on this fundamental metric.

The Project has published its research into the conduct costs of sixteen of the largest banks incurred for the period 1 January 2008 onwards. Below is a summary of the Project’s findings in the form of a table of conduct costs for the five-year period ending 31 December 2014.

As can be seen, the conduct costs incurred by those banks over that period (including provisions as at the end of 2014) came to more than £200 billion; not an insignificant sum. And, while the Foundation’s research into the 2015 figures is ongoing (with the addition of further banks, taking the total to 21 of the world’s largest financial institutions), it is regrettably anticipated that the level of conduct costs as at the end of 2015 will be of equal (if not greater) magnitude. The Project expects to publish a revised Results Table in May 2016, accompanied with updated summary analysis. Access to the detailed data underlying the results (and the opportunity to explore more in-depth analysis and correlative research) is, however, limited to member’s of the Project’s Association. Those interested in becoming members are welcome to contact the authors.

CISI members may also be interested to hear that, among its other projects, the Foundation is working with Cambridge Judge Business School to develop (through active and collaborative engagement with/by the banks) a set of best practice, tested and ethically-centric standards that assist firms in navigating, specifically, ‘grey areas’ with high conduct risk (such as where traditional regulation fails to provide a definitive answer). Further details of the ‘standards project’ will be available on CJBS and the Foundation’s websites in due course.

A presentation on the work of the CCP Research Foundation to CISI members by Roger McCormick and Chris Stears in February 2016 is now available on CISI TV

### Conduct Cost Disclosure

There is currently no enforceable requirement for banks to make specific, full and meaningful disclosure of conduct costs. As such, published annual reports and accounts, constructed under GAAP and IFRS rules, contain no readily comprehensible report on conduct costs and their implications. Meaningful disclosure is voluntary and only then in so far as the organisation is required to report ‘material events’. There are clear differences in the terminology and granularity used by banks, with conduct costs often subsumed within an aggregated accounting entry marked, for instance ‘litigation cost’ or ‘other expenses’. The aggregation of conduct costs conflates disparate operational costs: not all litigation costs are rightly considered conduct costs in the sense that they may arise otherwise than as a result of ‘misbehaviour’. This practice does not assist the bank in identifying what misbehaviour looks like (and its current and future cost (financial and non-financial). This issue is recognised at the European regulatory level, with the European Banking Authority’s (EBA) Risk Assessment Questionnaire (RAQ) providing some conspicuous results. The EBA notably reported that:

Claims have nevertheless often been made that there are challenges to quantify aggregated redress costs. While expenses provided for compensation and redress payments have increased, rising and increasingly materialising conduct risks raises the questions as to whether risks are sufficiently provisioned for, and whether provisioning is adequately disclosed. Claims have been made that there is a lack of disclosure on details of redress costs, and responses to the RAQ provide indications that some of these claims could be justified. Only 18% of the RAQ respondents indicated that they set aside and disclose contingent liabilities for potential compensation, redress, litigation and similar payments, and disclose them. (Authors’ emphasis)

### Conduct Costs for the Five Years Ending 2014 in £Bn

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<tr>
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<td><strong>Grand Total [GBP Bn]</strong></td>
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<td><strong>45.44</strong></td>
<td><strong>205.75</strong></td>
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Source: CCP Research Foundation