

Financial Services Authority

# FSA Scale and Impact of Financial Crime Project

– Impacts of Financial Crimes and  
Amenability to Control by the FSA:  
proposed framework for generating  
data in a comparative manner





## FSA Scale and Impact of Financial Crime Project

Impacts of Financial Crimes and Amenability to Control by the FSA:  
proposed framework for generating data in a comparative manner

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# Impacts of Financial Crime and Amenability to Control by the FSA

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## Impacts of Financial Crime and Amenability to Control by the FSA

### Preface, acknowledgement and limitations

This report was commissioned, prepared in draft in July 2008, discussed between the Financial Services Authority and the authors and then externally reviewed in September 2008. Both the FSA and the authors thank Professor Peter Reuter of the University of Maryland, who acted as reviewer. In understanding the report as a whole, it is important to emphasise the question being addressed: how might scarce supervisory resources be allocated for financial crime prevention and enforcement purposes? (We were not asked to address questions about prudential regulation raised by the systemic crisis in the financial markets; and no attempt has been made to revise the work in the light of recent events.)

In relation to the report's overarching framework and recommendations – development of information on (i) the impacts of criminality and (ii) its amenability to control by the FSA both working alone and with its partners – Professor Reuter's review said that this report makes 'a good case for being able to do relatively well at measuring its impact and amenability to FSA regulation'. This provides 'an analytic frame for discussion of the policy issues', whilst acknowledging data problems, including 'problems of misinformed complainants and other sources of information bias'. A number of detailed points, primarily on money laundering aspects, were made, which have led to fine-tuning of the text prior to 2009 publication.

Crucially – and breaking with what is often regarded as an orthodoxy in the UK and elsewhere – both the authors and the referee maintain that attempts to measure the scale or extent of all financial crimes are not a central or immediate task for the FSA. This is partly because, as research over the last decade or so shows, 'sizing' money laundering and other financial crimes within the purview of the FSA has proved fraught with serious difficulties, which are unlikely to be resolved convincingly, within margins of error that are small enough to help the FSA to fine-tune its actions or to track its performance. Fortunately, in the view of the report authors, measuring the scale of financial crime is not necessary for the FSA itself. What *is* desirable, this report claims, is to estimate the impacts of laundering and of other criminality upon FSA-regulated markets, entities and customers; and also to estimate the amenability of these different forms of financial crime to control (that is to say, how much influence a variety of actions by the regulator might have on those impacts).

These claims may be controversial for some, even though they are based on the best evidence and research currently available. However we and the FSA aim to provoke a full and open debate on these important issues of tasking and performance management for the prevention of financial crimes.

## Impacts of Financial Crime and Amenability to Control by the FSA

### Acronyms and terms used in this report

ACPO	Association of Chief Police Officers
AML	Anti-Money Laundering
ARROW	Advanced, Risk-Responsive, Operating frameWork
CPS	Crown Prosecution Service
CoLP	City of London Police
CFT	Combating the Financing of Terrorism
CTF	Counter-Terrorist Finance
EU	European Union
FACI	Forensic Accounting and Corporate Investigation
FATF	Financial Action Task Force
FC	Financial Crime
FinCEN	Financial Crimes Enforcement Network
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act 2000
IMF	International Monetary Fund
MFA	Market Failure Analysis
ML	Money Laundering
MO	<i>Modus Operandi</i>
NERA	National Economic Research Associates
NFA	National Fraud Authority
NFRC	National Fraud Reporting Centre
OFT	Office of Fair Trading
Project	FSA Scale and Impact Project
SAR	Suspicious Activity Report
STR	Suspicious Transaction Report
SOCA	Serious Organised Crime Agency
UN	United Nations

## Impacts of Financial Crime and Amenability to Control by the FSA

### **1. SUMMARY OF CONCLUSIONS, RECOMMENDATIONS AND NEXT STEPS**

This draft final report is driven by the FSA's Scale and Impact Project, which aims to derive ways for the FSA to allocate its resources against a range of financial crimes in an evidence-based and intellectually defensible manner.

#### **1.1. Summary of conclusions**

The report recommends the development of two top-level indicators, representing what can be known or estimated (i) about harmful impacts of financial crimes and (ii) about their amenability to actions by the FSA and (where appropriate) partner agencies.

Drawing methodologies for developments of (i) and (ii) from existing analysis of and research on the three main 'branches' of crime that are of concern to the FSA – frauds, money laundering and market abuse – we suggest that these methodologies be further developed and applied in comparative work across all such crimes.

The outcome would be that the management of the FSA, when considering resource allocation, would be able to take into account adverse impacts and amenability to control of specific financial crimes.

A top-level impact indicator would draw upon three forms of data: discernable market movements generated by financial crimes; complainants generated; and costs generated. 'Response costs' (costs of activities in anticipation and ex post facto management of financial crime) should be *excluded* from this analysis, because to include those costs would incorporate an inappropriate positive feedback mechanism in decision-making.

A top-level amenability indicator would take account of whether victims and resistant-to-victimisation persons/firms perceive particular forms of FC as being amenable to specific FSA measures (including advice, supervision and enforcement); whether perpetrators do; and whether firms' risk, audit and compliance departments/officers do (for some or all of their business sectors).

Crimes that are both of high impact (in terms relevant to the FSA) and highly amenable (to control by the FSA) would be prime candidates for prioritisation of resources by the FSA. Crimes that are of low amenability as well as being of low impact would normally be candidates for less intense action by the FSA. Other combinations, for example high impacts and low amenability, are more problematic. At various places throughout this report we make some asides as to what is known about levels of impacts and amenability of various financial crimes. However it would be premature to try to draw that picture fully now. The fuller picture would be the outcome of the work that we recommend.

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### 1.2. Summary of general recommendations

- A. When considering the allocation of its supervisory and enforcement resources to its three main financial crime concerns, the FSA should compare these crimes in terms of their impacts and their amenabilities to control by FSA action. Those main crime categories (and sub-categories thereof) that are relatively high in terms of both impacts and amenability to control should attract higher levels of supervision and enforcement action.<sup>1</sup>
- B. In developing its future requirements for development of methodologies and datasets for this process, the FSA should draw on partners' existing datasets where these are already available and are adaptable to FSA purposes (mostly the case on the 'costs' aspect of impacts). It will need to focus its own efforts on developing methods and measures of crime types' amenability to control by FSA-specific action.
- C. The definition of impact for FSA purposes should be limited to direct costs and (where applicable) broader social costs. Response costs should not be included, since determining a proportionate level of these is an objective of the exercise.

### 1.3. Summary of suggested next steps

#### 1.3.1. Focus on and comparing specific crime types

There are several alternatives for practical ways to develop the Project work programme:

- (i) empirical work in relation to one particular crime type (for example, a certain type of fraud), looking at it in terms of all aspects of impact and amenability; or
- (ii) comparing several crime types in terms of all aspects of impacts and amenability; or
- (iii) comparative work, across many different crime types, but in relation to just one aspect (or some aspects) of impact or amenability.

For reasons explained in Section 6.2.1 below, we suggest that alternative (iii) above is most practical for action in the near-term and that the FSA should prioritise:

- *exploring if and how work on market movements/distortions could be developed in relation to financial frauds and money laundering;*  
*and/or*
- *developing amenability indicators based on the practical experiences of victims, resistant persons and perpetrators, across financial frauds and money laundering.*

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<sup>1</sup> Enforcement measures may properly have regard to how likely the particular firm or individual is to comply with FSA pressure, so we do not mean that greater potential harm should automatically mean tougher punishment. Regulation and retribution have different logics. Our regulatory orientation in this report is part of why we separate out harm from amenability.

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### ***1.3.2. Improving impact data***

With regard to the next steps in research of impacts, there is a need for data on market distortion, and the Financial Crime and Intelligence Division may want to communicate such interests to colleagues working within the FSA on market cleanliness in relation to market abuse. As and where appropriate, attempts should be made to develop such methods in relation to market distortions caused by major frauds (or by extensive low-level frauds, such as widespread mortgage fraud) and in relation to money laundering. It would also be useful for the FSA to commission internal or external exploratory work and piloting in these areas.

With regard to next steps in relation to complainants and direct costs, the FSA may want to set up a small project, in-house or externally, to contact all government bodies and private sector firms potentially interested in commissioning crime costs estimates over the next few years, communicating the FSA'S interests.

### ***1.3.3 Improving amenability data***

One option for taking work forward in this area is for the FSA to undertake or procure qualitative research on the experiences of regulated persons and their customers targeted by financial criminals, possibly focusing initially more on fraud and on money laundering than on market abuse. Such research would examine which, if any, powers and activities of the FSA are seen as having been neutral, supportive of financial crime-resistance (albeit not wholly successfully, in the case of victims) or counterproductive.

The sample of persons should aim to cover both victims (including repeat victims), those who were resistant to all approaches by fraudsters and those who were victims on at least one occasion and resistant on at least another. This qualitative research should have as its objectives the generation of preliminary information and the design of further, quantitative work.

In short, in managing the forward path of the Scale and Impact Project, the FSA should seek reasonable-quality data on impacts and amenability, across all financial crimes of concern to the FSA. This comparative method will support evidence-based decision-making on allocation of regulatory resources and work with partners in the UK and internationally.

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### **2. THE APPROACH PROPOSED**

#### **2.1. Purpose and general approach**

One of the objectives of the FSA is reduction of financial crime, expressed as follows ‘reducing the extent to which it is possible for a business carried on by a regulated person to be used for a purpose connected with financial crime’. The present report is one of two deliverables within a study tasked with development of methodology through which the FSA can allocate its resources concerning the above objective. The FSA’s requirement was for:

A financial crime typology that relates to the concepts of harm (including harm to individuals and harm to society), measurability and market failure (in the economic sense, i.e. situations in which regulatory intervention may be justified because markets have failed to provide solutions to the market imperfections associated with financial crime). To identify what market and other mechanisms the FSA, given its legal powers, can realistically use to bring about a reduction in financial crime, and advise the project on which types of crime it is feasible to attack and which may defy our best efforts.

The requirement underlines that the FSA needs to know which aspects of market failure leading to criminality it can effectively address (where it can make a difference). After all, knowing the scale or impact of various aspects of financial crime, but without knowing which of these the FSA can effectively address, would be unhelpful. So, a typology of financial crime *for the FSA* should be cast not solely in terms of financial crime and its harms, but also in terms of different financial crimes’ vulnerability to regulatory actions, including the FSA’s stimulation of private sector and/or law enforcement/other public sector actions in the UK and elsewhere.<sup>2</sup> Although we often speak of ‘financial crime’ as if it were a unitary object, our aim and that of the FSA is to unpack this collective term in a purposive way, facilitating targeted actions.

In this report we have taken into account our discussions with the Project Board; and Matt Fleming’s report, in particular its key messages on quality and appropriateness of methodologies. Fleming’s report defines fitness-for-purpose of data in terms of data relevance and data quality and it focuses on the latter. In the light of the above, JH&Co employed methods of literature review and internal model-building, as well as dialogue with the Project Board. We focussed on crime risks in FSA-regulated markets and on what methodologies would be appropriate for identifying “what market and other mechanisms the FSA, given its legal powers, can realistically use to bring about a reduction in financial crime, and advise the project on which types of crime it is feasible to attack...” We do not focus on formal criteria for data quality, since that is well covered by the Fleming Report.

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<sup>2</sup> We appreciate that some actions may be taken under the umbrella of the National Fraud Authority (NFA) and other bodies, so references to FSA stimulation include both direct and indirect ‘badging’ of initiatives. The NFA is responsible to the Attorney General of England and Wales, and has a broad range of private and public sector stakeholders in its fraud reduction objectives.

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### 2.2. Proposal for indicators of impacts of financial crimes

Our methodological recommendation in relation to impacts of financial crimes frauds, laundering and market abuse is summarised in the following table. In the following chapters, methods for answering questions 1 to 3 are explored (to a limited extent and in an illustrative rather than definitive manner).

<u>Impact methodology summary</u> Comparison of financial crime events in terms of some signs they leave behind – towards a methodology (combining indicators from Q1, Q2 and Q3)			
	<i>Q1: Are discernible market movements generated?</i>	<i>Q2: Are complainants generated?</i>	<i>Q3: Are there indications of costs borne?</i>
<b>Fraud</b>	See following pages	...	...
<b>Money laundering</b>	...	...	...
<b>Market abuse</b>	...	...	...

Question 1. Given its role of safeguarding the integrity of markets, the FSA has a particular interest in being able to identify and react to distortions in markets caused by criminality. This interest is well developed in the market cleanliness work of the FSA carried out in relation to market abuse. It is also reflected in a standard methodology of the FSA, Market Failure Analysis (MFA, see section 2.5 below). We were asked to take into account both MFA and the work done on market abuse. Without going into the details at this point in the report, we find that the *general concept* underlying regulators' scrutiny of financial market price movements, looking for market failure, has also been utilised in work on frauds (namely, mortgage fraud in the US) and on money laundering (unexpected trade and money flows, and disparities in prices from the norms prevailing in commerce). There are of course many conceptual, technical and methodological differences, depending on the market sectors involved and available data. However one can discern a general theme of tracking market distortions resulting from financial crime. In this report we point to the possibility and desirability of making *comparative statements* about the extent of market distortion resulting from financial services frauds, laundering and market abuse. This would be one of three ways in which the evidence base on impacts could be strengthened.

Question 2. A second form of evidence about adverse impacts of financial crimes is the existence of complainants. The presence or absence of complainants alone does not provide a full evidence base on impacts, but data on this point, together with data regarding market distortions and aggregate financial costs, does permit the

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drawing of more secure conclusions than would any one of these datasets alone. Not all fraud losses produce complainants, for several reasons. Losses may be distributed thinly over many market participants, and may be regarded as normal contingencies of trade: in such cases, there are few if any complainants. In other cases, those hurt by financial crimes (or whose facilities are used to hurt third parties) may not even realise this. On the other hand, when losses fall upon individual persons or firms to an extent that is high in relation to their total assets (especially liquid assets), then complainants are more likely to make themselves heard, and are likely to be regarded as strong evidence of harm. Despite many remaining difficulties, data on such complainants helpfully add to those on market distortions and aggregate financial costs.

Question 3. A third form of evidence about impacts of financial crimes arises in the form of costs falling on victims. Aggregate financial costs of crime are commonly expressed in terms of direct and indirect costs. *Direct costs* are understood in terms of the economic value of losses falling upon victims of crime and in terms of some broader social (including emotional) costs, some of which may not be capable of being monetised sensibly. Methods for capturing direct impacts include reported losses by firms and individuals, scaled up in accordance with evidence/indications of the ratio of reported to unreported financial crimes events (as discussed in the Fleming report and elsewhere).<sup>3</sup> Some losses may be reported in confidential industry surveys but not to the regulator or to the police. The data collection problems are well known – incomplete reporting, ‘dark figure’ of financial crime, etc<sup>4</sup> – but the OFT 2006 report illustrates some of what can be done. Below we make recommendations for improvements in order to capture data that are both accurate (as per the discussion in the Fleming report and in Levi *et al*, 2007) and relevant.

*Indirect costs* are the costs incurred by individuals, firms and public agencies in anticipating, preventing, responding to and mopping up after financial crime. These indirect costs are also called ‘response costs’ in this report. For reasons we now shortly discuss, we do NOT recommend that the FSA follow the standard UK government approach of including in costs of crime estimation the costs of anticipation (crime prevention) or the costs of responses by government and/or the private sector.<sup>5</sup> Such data are included in some government estimates, for example

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<sup>3</sup> Levi *et al* 2007 op cit; also Levi, M and Reuter, P, 2006, Money Laundering, in *Crime and Justice* (ed. M. Tonry): Chicago: University Press, pp 289-374.

[http://www.publicpolicy.umd.edu/faculty/reuter/Working%20Papers/Levi\\_and\\_Reuter.pdf](http://www.publicpolicy.umd.edu/faculty/reuter/Working%20Papers/Levi_and_Reuter.pdf)

See also Shover, N, Glenn S. Coffey, G and Hobbs, D, 2003, Crime on the line: Telemarketing and the changing nature of professional crime, *British Journal of Criminology*, 43, July, pp 489-505.

<sup>4</sup> What should also be appreciated is that at any given moment in an FSA or police investigation, the awareness that the investment is a scam may not have crystallised, and some ‘victims’ may not see that they have been defrauded even when confronted by the police. It is also plausible that even when they lose their money, they may have been persuaded/persuade themselves that they have lost money other than by the fraudster’s actions. So any survey method that asks/requires them to report ‘frauds’ will not capture the latter cases of ‘cognitive dissonance’ or ‘denial’.

<sup>5</sup> The general source is Home Office study HORS 217 and various preparatory and follow-up studies, see summary at [http://www.homeoffice.gov.uk/rds/economic\\_fags.html#one](http://www.homeoffice.gov.uk/rds/economic_fags.html#one): ‘The cost of a crime is the burden or loss of well-being that results from a crime. It includes: costs in anticipation of crime such as installation of alarms and security features and the purchase of insurance; costs as a

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those compiled by the Home Office, for two good reasons: response costs are indeed incurred, and data on them may be of reasonable quality (sometimes of better quality than estimates of the direct costs of crimes), not least because some of them are the product of the Home Office's own model for allocating resources to the police. In constructing an overall 'cost of the problem' that includes response costs (public and private), government is enabled to arrive at impressive costs for those crimes that are at the heart of public concern and already attract vigorous and expensive responses. However, a fundamental problem arises if these same overall figures are used to justify future resource allocation – one then finds that future resource allocation is to a large extent driven by past resource allocation. Such an approach conveys the appearance that, if one redoubles one's efforts in relation to any crime category, then the costs thereof increase, potentially leading one to allocate more resources to that category, and so on.<sup>6</sup> Such a positive feedback mechanism is not suitable for budget allocation. Indeed one can see this in reverse in fraud resource allocation, where historically slight resourcing feeds into relatively low estimates of 'the cost of fraud'.<sup>7</sup>

In summary, there should be three 'legs' to impact data – on market distortions, complaints and (direct) financial costs.

### 2.3. Proposal for indicators of amenability to FSA control

To what extent do particular FSA powers and actions have leverage in terms of 'reducing the extent to which it is possible for a business carried on by a regulated person to be used for a purpose connected with financial crime', from the perspectives of those most intimately involved?

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consequence of crime itself, including property stolen or damaged and emotional and physical costs of injuries sustained as a result of crime; and costs of the response to crime, including costs to government of the Criminal Justice System (CJS).' Unfortunately for present purposes, the same source says that the Online Report "Organised crime: revenues, economic and social costs, and criminal assets available for seizure" has been withdrawn (in 2007 and continuing as of June 2008, awaiting ministerial sign-off). Prior to its withdrawal, we have however been able to consult that report as background.

<sup>6</sup> A similar problem would arise were one to include, within indicators of impact or amenability, an indicator of public or political concern over certain types of financial crimes. In such a case, an increase in concern would drive the indicator, which in turn could drive concern, and so on. To point this out is of course not to imply that management should be deaf to shifts in public or political concern: such considerations would be taken into account *in addition to* evidence about impacts and amenability, *not within them*. Otherwise one risks inflating or deflating harms independent of trends in their incidence, prevalence and effects on victims. If there was a rapid rate of change in a particular type of fraud, this would be important whether or not it led to public alarm: though of course, widespread panic among victims and those who believed themselves to be at risk of becoming victims might lead to systemic risk. (This might happen irrespective of whether or not *crime* was involved or was believed to be involved.)

<sup>7</sup> The relatively few fraud cases that are pursued to contested trials generate a high proportion of the costs to taxpayers of long trials generally: but it is important to see these costs in the context of wider objectives of social fairness, just deserts and deterrence. The desire to avoid such taxpayer costs may influence preferences for regulatory rather than criminal justice interventions, or even for doing nothing, thereby generating a culture of impunity.

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<u>Amenability methodology summary</u>			
Comparison of financial crime events in terms of amenability to control by FSA – towards a methodology (combining indicators from Q4, Q5 and Q6)			
	<i>Q4: Do victims and/or resistant persons describe financial crime as amenable to FSA measures?</i>	<i>Q5: Do perpetrators describe it as amenable?</i>	<i>Q6: Do experienced risk professionals describe it as amenable?</i>
<b>Fraud</b>	<i>See following pages</i>	...	...
<b>Money laundering</b>	...	...	...
<b>Market abuse</b>	...	...	...

For each major crime category, the FSA should commission or undertake internally research into its amenability to control, in relation to the various forms of instruments available to and actually deployed by the FSA. The broad question is, what influence does actual and perceived regulation have upon decision-making by potential victims and by perpetrators? If empirical information on amenability could be generated (as distinct from the impressions of FSA staff as to the worth of their work, or what custom models may suggest) then FSA management would have the possibility of directing resource to the areas in which they may do most good.

For example, if victims, resistant persons/entities, perpetrators and risk professionals working in regulated firms were all to identify a practical regulatory practice as effective in protecting potential victims or dissuading perpetrators, then (other considerations being equal) the FSA might wish to step up efforts in that area. Conversely, where indications are given that particular FSA actions or advice are not having much influence, then the options would include *either* changing that practice *or* putting fewer resources into it.

To obtain such ‘at the sharp end’ information, key informants in this context should include:

- victims, asking whether they were aware of any aspects of regulation that might have protected them yet which they disregarded. If so, what aspects and what led them to disregard them, etc<sup>8</sup>
- resistant persons/firms, that is to say those who have been targeted but did not become victims, asking then what made them disinterested in, suspicious of or

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<sup>8</sup> Though this might not be definitive, since many but not all people tend to be in denial about their own contributory negligence and tend to project blame onto others.

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downright resistant to financial crime 'offers'; and what, if anything, they believe this resistance had to do with regulation<sup>9</sup>

- perpetrators, because they are specialists in the victim-making and resistance; how do they see things and what is the relevance of various aspects of regulation in facilitating victimisation/resistance<sup>10</sup>
- risk, audit, compliance and security professionals who have knowledge of FC because of their experience in a range of regulated firms, their surveillance of such firms in their professional capacity (for example auditors), or their contracted work for example after major breaches of ethics or security (corporate security/FACI<sup>11</sup>).

Few studies exist internationally in relation to such aspects of financial crime. This may be because, as has been observed elsewhere, "the populist agenda of what 'the crime problem' constitutes appears to have frozen both victimisation surveys and 'fear of crime' studies into a conventional view of what sorts of acts they should be looking at".<sup>12</sup> Nevertheless there is no scientific reason to restrict victim (and perpetrator) studies to 'street crime' and 'organised crime': indeed studies of financial crime could constitute an important information resource, especially if placed alongside the contributions made by risk professionals.

Preliminary work should address the question of the best language within which to discuss regulation (FSA advice-giving, supervision and enforcement) with respondents. Some possibilities are:

- to use respondents' own categories (and to cluster and group them in ways that make sense to respondents)
- to use as research 'prompts' the FSA's favoured categories of its regulatory actions and to explore with respondents whether the intended effects were experienced by them in practice.

Whilst we recommend that this question of best language should be explored empirically, good practice in research would suggest that both of the above approaches should be used (first the open-ended approach and then the prompts). Research methodology might be developed through three phases: preliminary, qualitative exploration, with 'convenience sampling'; constructing and piloting a mechanism for the main phase; main phase with properly drawn samples.

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<sup>9</sup> Here we may find that personality, independent of actual regulation, is a key influence on susceptibility to fraudulent telemarketing or other frauds within the FSA's purview.

<sup>10</sup> In the aftermath of successful enforcement operations, sanctioned offenders may be more readily available for interview and de-briefing than would be plausible normally.

<sup>11</sup> FACI industry: forensic accounting and corporate investigation industry. See Williams, J, 2005, Reflections on the private versus public policing of economic crime, *British Journal of Criminology*, 45, pp 316-339.

<sup>12</sup> Chapter 3, Perceptions of fraud seriousness: attitudes of the general public, business executives, and victims. Levi and Pithouse, in preparation, *White-Collar Crime and its Victims*. See also Levi, M., 2009, 'Fear of Fraud and Fear of Crime: a Review', *The Criminology of White-Collar Crime*, [Editors S. Simpson and D. Weisburd] New York: Springer.

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### 2.4. Bringing impact and amenability data into one management summary

Six questions recur throughout the report, with provisional remarks on methodologies for using existing data and/or commissioning new data. By applying these six questions to market frauds, money laundering and market abuse (and sub-categories of these), the FSA may considerably enhance its decision-making on prioritising its actions and allocating its resources in relation to these financial crimes.

<b>Framework for management summary</b>				
<b>IMPACTS of financial crimes</b>	Q1: Are market movements (distortions) generated? - Yes strongly - Moderate - Unclear or no	Q2: Are complainants generated? - Yes strongly - Moderate - Unclear or no	Q3: Are there indicators of costs? - Yes strongly - Moderate - Unclear or no	Take the general indication of Qs 1-3.
<b>AMENABILITY to control</b>	Q4: Do victims and/or resistant persons describe this FC as amenable to FSA measures? - Yes strongly - Moderate - Unclear or no	Q5: Do perpetrators describe this FC as amenable? - Yes strongly - Moderate - Unclear or no	Q6: Do experienced risk professionals describe it as amenable? - Yes strongly - Moderate - Unclear or no	Take the general indication of Qs 4-6.
<b>IMPLICATIONS</b> Implications for resource allocation to be discussed in the light of all above (though this is not a mechanical process).				

Political tasking apart, an evidence-based approach would be to prioritise for action those crimes that data suggest are high on impacts and also amenable to action by the FSA (c.f. Figure 1 below). In many cases, and for the foreseeable future, the data may be ambiguous and that is a good reason to triangulate for both impacts and for amenability. In the short term, in-house assessments may supplement patchy data; in the medium term, the data will need to be improved.

The concept of a typology, which animates the Requirement for this study, may be operationalised as the positioning of specific financial crimes within a simple two-by-two dimensional space defined by impacts of those crimes and their amenability to FSA control. The basic form of this is given by the figure immediately below.

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Figure 1. Outline typology of FSA priorities in terms of financial crime impacts and amenability to FSA control

IMPACTS OF FC	High	<p>Quadrant A Very harmful FCs not amenable to FSA (problematic category)</p>	<p>Quadrant B Very harmful FCs and amenable (prioritise FCs in this quadrant)</p>
	Low	<p>Quadrant C Not so harmful, non-amenable (de-prioritise)</p>	<p>Quadrant D Not so harmful but amenable</p>
		Low	High

AMENABILITY TO FSA CONTROL

Articulating this vision of the FSA’s forward information requirement (for the purpose of deciding resource-allocation), we divide the following sections of this report into sections on financial frauds, money laundering and (in less detail) market abuse (legal categories that correspond with FSA tasking), bringing relevant aspects of the literature and some data to bear on these three main FC categories.

### 2.5. Does the proposal fit with other FSA methodologies?

A crucial question about any proposal is whether it is consistent with the operating procedures and capacity of the organisation or system in question. We say that it is, based on our discussions with internal stakeholders and our reading of briefing papers, which have helped our team to understand how the FSA currently allocates its financial crime resources. We have considered and explored how our proposals may fit in with the FSA’s existing processes. At present, financial crime resources are allocated by FSA management using ARROW - which involves a series of judgments about firms, sub-sectors, themes and process – and by the ‘Dashboard’ process, whose ‘impact and probability metrics’ provide a prioritisation mechanism.

The Dashboard process is:

1. define the risk,
2. score the risk,
3. assess if the markets are achieving a solution to the risk,
4. assess the impact of possible interventions (their costs and other possible negative impacts) and
5. set a target outcome deadline.

## Impacts of Financial Crime and Amenability to Control by the FSA

Analytical inputs into the Dashboard currently include Market Failure Analysis (MFA, corresponding to stages 1 to 3 of the Dashboard process) and Cost Benefit Analysis (CBA, corresponding to stage 4). MFA is a certain form of economic analysis that addresses the question of whether or not there is a case for regulatory action, principally by looking for evidence of information asymmetry, externalities and market power, seeing these as symptoms of market failure.<sup>13</sup> If such signs are observed (beyond an agency-set threshold), then a Cost Benefit Analysis (CBA) is performed. MFA has its critics, both sympathetic<sup>14</sup> and otherwise;<sup>15</sup> however our concern here is not to evaluate expert commentaries on MFA.

We propose that the proposed analysis of financial crime in terms of impacts and amenability can feed into the Dashboard, alongside MFA and other current inputs, thus adding new insights, categories of data and empirical sources. This would mitigate some acknowledged weaknesses in current procedures. An FSA internal paper comments that:

At present, the most difficult items on the [Dashboard] list involve the scoring of risks and the impact of possible interventions [by which is meant the success or otherwise of interventions]. The issue for consideration is whether these two items should be the ultimate end point for the scale and impact project and, if they are, how would concepts/methodologies to measure the scale and impact of financial crime assist?<sup>16</sup>

We suggest the methods developed in the present study are helpful in addressing both of the problems noted in that FSA internal paper, as follows.

- The FSA Dashboard process of ‘scoring of risks’ of risks can be bolstered by the methodology suggested for tracking impacts of financial crime (through market movements, complaints and costs).
- The FSA internal paper’s ‘impact of possible interventions’ is our ‘amenability to control by FSA’ (as perceived from the vantage points of victims, resistant parties, perpetrators and risk professionals).

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<sup>13</sup> FSA, 2006, A guide to market failure analysis and high level cost benefit analysis, London: Financial Services Authority, pp 60. [http://www.fsa.gov.uk/pubs/other/mfa\\_guide.pdf](http://www.fsa.gov.uk/pubs/other/mfa_guide.pdf)

<sup>14</sup> Arthur, T and Booth, P, 2006, Financial regulation, the state and the market: is the Financial Services Authority an unnecessary evil? *Economic Affairs* 26 (2), pp 22-30.

<http://www.ingentaconnect.com/content/bpl/ecaf/2006/00000026/00000002/art00004>

<sup>15</sup> McVea, H, 2005, Financial services regulation under the Financial Services Authority: a reassertion of the market failure thesis? *Cambridge Law Journal*, 64(2), July 2005, pp. 413-448.

<http://journals.cambridge.org/action/displayIssue?jid=CLJ&volumeId=64&issueId=02>

<sup>16</sup> FSA/Kordowski, J, 2007, Financial Crime Resource Allocation: Scale and Impact Project, pp 4, August, internal paper, London: FSA, Liaison & Assessment Team.

## Impacts of Financial Crime and Amenability to Control by the FSA

In summary, on the basis of material to hand and discussions we have had, we believe that the impacts & amenability approach elaborated in this report does have reasonable fit with the FSA's managerial tools and processes, whilst extending the possibilities for the FSA to engage more strongly with an *independent* and *empirical* evidence base.

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### **3. FINANCIAL FRAUD – IMPACTS AND AMENABILITY**

#### **3.1. What is fraud, in an FSA context?**

##### ***3.1.1. Fraud as a general category***

There are many ways in which fraud can be categorised. One way is in terms of the state of mind of the defrauded party. As Levi *et al* put in their study for ACPO:

there are three main types of investment frauds: (a) frauds in which investors do not believe that investments are FSA-authorized e.g. advance fee/some high-yield investment frauds involving 'secret inside information' or 'whisky/champagne' (i.e. boiler room scams); (b) frauds in which investors wrongly believe that the investments are FSA/other regulated; and (c) frauds in which investors correctly believe that investments are FSA/other authorised.<sup>17</sup>

Other approaches to categorisation include by the means of fraud, or by sector. Levi *et al* (op cit) classified private sector frauds thus: cheque fraud, counterfeit intellectual property and products sold as genuine, counterfeit money, data-compromise fraud, embezzlement, insider dealing/market abuse, insurance fraud, lending fraud, payment card fraud, procurement fraud. Clearly some of these (certainly counterfeit money, intellectual property and procurement) fall outwith FSA concerns unless they risk imperilling the survival of the firm, meaning data from existing fraud surveys would need to be re-worked in order to be relevant to the FSA.

#### **3.2. Impacts of frauds**

##### ***3.2.1. Are discernable market movements generated by fraud?***

Frauds should not lead to market movement unless capital adequacy is low (or the frauds particularly substantial) which they could be if the frauds were very large individually or in aggregate, as in mortgage fraud). Examples of large isolated frauds include Barings and Société Générale, where the positions taken were so large that the firm had a major impact on the share prices and general levels of market activity. The case of Enron, whilst it might seem to be yesterday's news in the light of the more recent and widespread debt market problems, nevertheless offers graphic illustration of the ways in which some frauds can move some markets.<sup>18</sup> Enron

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<sup>17</sup> Levi, M, Burrows, J., Fleming, M. and Hopkins, M with the assistance of Matthews, K., 2007, *The Nature, Extent and Economic Impact of Fraud in the UK*, Report for the Association of Chief Police Officers' Economic Crime Portfolio, February, pp 119.

<sup>18</sup> Coffee, J, 2003, What Caused Enron?: A Capsule Social and Economic History of the 1990's, *Columbia Law and Economics Working Paper No. 214*, 20 January, Columbia Law School, 51 pages, [http://www.law.columbia.edu/center\\_program/law\\_economics/wp\\_listing\\_1/wp\\_listing/211-220?exclusive=filemgr.download&file\\_id=69102&rtcontentdisposition=filename%3DWP214.pdf](http://www.law.columbia.edu/center_program/law_economics/wp_listing_1/wp_listing/211-220?exclusive=filemgr.download&file_id=69102&rtcontentdisposition=filename%3DWP214.pdf). Also Levi, M and Dorn, N, 2006, Regulation and Corporate Crime: Managers and Auditors European Journal on Criminal Policy and Research, 12, Numbers 3-4, December.

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reminds us of some of the structural conditions that allow large-scale frauds, and of the magnitude of market shifts that they can cause. It follows that regulators can and should regard rapid shifts in markets as reasons for suspicion, further investigation and modelling.

Similar conclusions may be derived from recent studies of the markets in real estate. Studies by FinCEN suggest that real estate is a market in which there is both fraud and laundering (on which see also chapter 4 below). In relation to residential real estate in the US, a 2008 study showed that:

Whereas a lending institution is virtually certain to file a SAR in instances where it is the target of either a failed or successful mortgage loan fraud for profit scheme which threatens the institution's revenues, the same lending institution may have significant difficulty in even identifying mortgage loan fraud perpetrated by the money launderer. This may explain the significant number of SAR filings reporting mortgage loan fraud for profit and the paucity of SAR filings reporting mortgage loan fraud to promote money laundering.<sup>19</sup>

Most of the entities' mentioned in US SARs concerning real estate were 'straw buyers' or 'front men' through which organisers bought many properties (ibid p 3). Sampling all SARs filed 1996-2006 that contained relevant keywords, and then narrowing down by inspection to those related to residential real estate, FinCEN found that one fifth described suspected structuring and/or laundering. Organisers paid many mortgage companies simultaneously, using low-denomination cheques. Corrupt real estate values and bank officials allowed false property valuations and buyer income profiles to be deployed, in one case leading to \$6.4 million being obtained using false appraisals (p 11).

### **3.2.2. Are complainants generated by frauds?**

This question has two components; (1) whether complaints are generated and, (2) if so, whether they come early enough in the fraud's life cycle to be useful.

1. Are complaints generated at all for any given offence? This is a function of:

(a) the realisation or belief that one has been defrauded or has some other basis for complaint (e.g. on Treating Customers Fairly lines<sup>20</sup>);

(b) the belief that there is a point in reporting (restitution, punishment, and/or general prevention for other potential offences) or an obligation to report (e.g. 'significant' frauds against FSA-regulated bodies, though we are not aware that any

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<sup>19</sup> FinCEN, 2008, Suspected Money Laundering in the Residential Real Estate Industry An Assessment Based Upon Suspicious Activity: Report Filing Analysis, April, Washington: FinCEN, cited at p 2 of 21, [www.FinCEN.gov](http://www.FinCEN.gov)

<sup>20</sup> The total number of disputes dealt with by the Financial Ombudsman Service rose by 30% to 123,089 in the 2007/08 financial year: however, few of these (presumably) were about fraud. (See <http://www.financial-ombudsman.org.uk/publications/ar08/index.html>).

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enforcement action has been taken against non-reporting, nor has 'significant' been defined with any clarity);

(c) the belief that the FSA is the appropriate body to complain to (an issue that may be less relevant after the National Fraud Reporting Centre (NFRC) comes on-stream).

2. At what stage of the fraud's life cycle are complaints made? Here we should distinguish between drip-feed and mass marketing frauds, on the one hand, and large one-off frauds, on the other. In the former cases, if connected as part of a series, early notification could – if acted upon by the FSA or some other body such as the OFT or police/CPS/SFO – lead to significant harm reduction; in the latter case, notification would be too late for immediate harm reduction but might be a helpful indicator of risk to others in the market if that risk were to be made known to them, anonymised if necessary.

We take as an example boiler rooms. Here, although there are some complainants - whose numbers can rise dramatically, especially in 'spikes' after media publicity - most of those victimised appear not make a complaint 'naturally', and not to the FSA.<sup>21</sup> To the extent that victims speak about their experiences to others, this may have a more widespread effect on investment behaviour (though alternatively, it may warn others about the *modus operandi* of boiler rooms and help them to resist). As with other 'fear of crime' issues, there may be broader impacts than those occurring simply to losers, but neither attitudes to future investment nor actual changes in investment practices have not been assessed in the research literature.<sup>22</sup>

### 3.2.3. Are there indicators of costs of fraud?

Because frauds by definition have specific targets/victims, (potential complainants, even if not all understand or report their losses), the situation regarding impacts is conceptually somewhat clearer here than is the case for market abuse (where targeted victims sometimes may be more difficult to define and the concern may focus more around market integrity/cleanliness or jurisdictional reputation effects on levels of financial services business). In short, even if many of the victims may be shy and if, for this and other reasons, establishing their costs empirically is no easy matter, victims of fraud do have attributable costs. In some cases, those costs may fall upon the direct victims alone (e.g. boiler rooms and advance fee frauds); in others, they may be distributed more widely via insurance (including professional indemnity insurance) or via the assumption of liability by third parties (e.g. card

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<sup>21</sup> See, e.g., FSA, 2006, Press Release FSA/PN/053/2006, Typical boiler room victim loses £20,000, warns FSA. <http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/053.shtml>; FSA, 2007, Financial Crime Newsletter Issue No. 9, p5. [http://www.fsa.gov.uk/pubs/newsletters/fc\\_newsletter9.pdf](http://www.fsa.gov.uk/pubs/newsletters/fc_newsletter9.pdf); FSA, 2008, Financial Risk Outlook 2008, p14. [http://www.fsa.gov.uk/pubs/plan/financial\\_risk\\_outlook\\_2008.pdf](http://www.fsa.gov.uk/pubs/plan/financial_risk_outlook_2008.pdf); BBC, 2008, Working Lunch (online article). [http://news.bbc.co.uk/1/hi/programmes/working\\_lunch/7375384.stm](http://news.bbc.co.uk/1/hi/programmes/working_lunch/7375384.stm); BBC, 2008, Money Programme (online article). <http://news.bbc.co.uk/1/hi/business/7306363.stm>; City of London Police, 2008, Operation Archway web pages. <http://www.cityoflondon.police.uk/CityPolice/ECD/Fraud/boilerroom.htm>

<sup>22</sup> Levi, M., 2009, 'Fear of Fraud and Fear of Crime: a Review', in *The Criminology of White-Collar Crime*, [Editors S. Simpson and D. Weisburd] New York: Springer.

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issuers, merchants and merchant acquirers with payment card fraud). Time taken and incidental expenses for victims of card and identity frauds in re-establishing credit ratings are costs uncompensated by the above, and which market participants currently have no incentive to pay for, though credit reference alert services are increasingly being offered by card issuers as an incentive for those worried about loosely defined 'identity theft'. In terms of amenability to control, there is a research job to be done in asking victims, resistant persons, perpetrators and market risk professionals to what extent, in their experience, the various powers and actions of the FSA may be reducing market frauds.

Introducing to the press the 2007 report to ACPO on frauds' costs to the UK,<sup>23</sup> City of London Police Commissioner Mike Bowron said: "it is likely that fraud represents a £20 billion annual loss to the UK. To put this figure into perspective, such losses would pay for an additional 200,000 police officers or save every man, woman and child £330.00 per year." These figures then became the latest additions to the many estimates in circulation. Yet, as Levi at al point out, their work represents a meta-estimate of *existing* studies, based on a variety of sources, many of them being better described as range estimates than as data, and where many sources are so under-developed that it is not possible to make any estimate. Following on from and building upon a broadly similar 2000 report by NERA, the ACPO study authors used international surveys from which UK data can be drawn, national level surveys, and administrative data compiled by umbrella organisations often focussing on particular types of fraud reflecting their funding and member interests.

Our concern here focuses upon those elements of fraud costs that impact negatively upon, or use as part of their *modi operandi*, FSA-regulated entities. The Levi *et al* work refers to some aspects of this. It looked at losses by firms in the financial sector, unfortunately for present purposes using a concept of financial services that is by no means contiguous with FSA regulated entities. The data would need to be re-worked to arrive at an FSA-relevant estimate or range. Summarising it as it stands (pp 3-4):

For businesses in the financial service sector (i.e. banks, building societies, finance houses, insurance companies and their agents), some data are quite robust and some result from the administrative record-keeping of members, which means that the data could be used tactically to prevent and/or respond to fraud. From the best evidence available, financial services' fraud losses are estimated at £1.005 billion in 2005. [...] However, the losses in the sectors above are complicated by the fact that a number of surveys of frauds against businesses do not separate out financial services from other sector losses in their reports. [...] Also] Fraud against private individuals paradoxically has received very little attention in any of the studies, being covered neither in the corporate fraud surveys nor in the public sector reviews.

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<sup>23</sup> Levi, M, Burrows, Fleming, JM, Matthew Hopkins, M, with assistance of Kent Matthews, K, 2007, The Nature, Extent and Economic Impact of Fraud in the UK, Report for the Association of Chief Police Officers' Economic Crime Portfolio, February, pp 119, London: ACPO.  
<http://www.acpo.police.uk/asp/policies/Data/Fraud%20in%20the%20UK.pdf>

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The authors underline that these fraud loss figures are merely indicative, existing sources of data on fraud being neither mutually exclusive nor collectively exhaustive. The UK/European/international data boundary remains hazy. So does the much bigger boundary between (a) 'frauds' as defined by legal action taken by the victims and (b) the many high value cases that appear to meet the criteria of criminal fraud that are investigated by forensic accounting and law firms, and are treated as civil matters for litigation and negotiation with 'suspects' and third parties.<sup>24</sup>

In other words, due to lack of prosecution (or even lack of awareness of victimisation in some cases) an unknown number of losses that could be labelled as costs of fraud are not. As a consequence of this reservation and others concerning the delineation of 'financial services' in the Levi *et al* work for ACPO, summary estimates published in that report cannot be taken as estimates for frauds 'reducing the extent to which it is possible for a business carried on by a regulated person to be used for a purpose connected with financial crime' (to cite the FSA anti-crime objective). Nevertheless, the methods pointed to, once adapted to the FSA perimeter, will be very relevant and provide one of the three legs of the tripod for gauging impacts of frauds (market movements, complainants and costs).

### 3.3. Amenability of frauds to FSA control

What practical difference does regulation make to decision-making by fraudsters' potential victims and to the perpetrators? This should be explored through research with the following categories of persons/firms, who are in a position to tell us (or if they are not, then no-one is).

#### **3.3.1. Do victims of frauds and/or resistant persons see frauds as being amenable to FSA measures?**

Samples should be drawn from complainants to the FSA and other agencies, also casting a wider net to find non-complainants (of whom OFT, interviews with City of London police and other work suggest that there are many). Methods should be developed for finding non-complainants and how to approach them, e.g. through networks – for example friends who may have passed on 'hot tips' before they realised the scam) and intermediaries who may know some of their clients have been scammed. From such sources, respondents could be asked about regulation, about their awareness of it, and in what respects (from their perspectives) it functioned in a protective manner, almost so functioned yet failed (and why) or was not at all protective.

To what extent did regulation plausibly play a role in building the resistance of those who, offered an opportunity to be involved in something that looked as it could have been fraud, make a decision to not facilitate it any way? Samples could be drawn in

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<sup>24</sup> C.f. Williams 2005 op cit.

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ways similar to recruitment of victims (above), noting that it may be easier to locate targeted but resistant persons/firms than those who were taken in.

There may be sensitivities, related to fears of potential reputational damage, were it to become known to social or business contacts that one was even approached and might have considered boiler room proposals. There will also be difficulties of validating the descriptions of resistance given, if respondents have a tendency to over-emphasise their capability to spot the scam very early on (a natural aspect of maintaining self-esteem). Careful qualitative work and piloting will be necessary in order to develop interview formats that accurately convey what occurred – the approach made, its terms, the emotional atmosphere, when exactly doubts became to be formed, what if any salience regulation had in this process, and so on.

### **3.3.2. Do perpetrators – financial fraudsters – describe themselves as being amenable?**

Several categories of financial fraudster, for example market manipulators (of whom boiler room scammers are a sub-set), have rarely been seriously researched (though see Stevenson, 1998 for an American ethnographic study).<sup>25</sup> However there is no reason why they should not be – most categories of criminals have been – and there could be considerable value in terms of comprehending their understanding of regulation and its salience for victimisation/resistance.

We recommend work to identify avenues for research approaches to under-researched financial market fraudsters – employees, middle managers and possibly beneficial owners. Several channels of approach are possible.

- Approaches through prisons are possible if and when any operators at any levels are jailed (virtually all other categories of criminals have been researched in prisons in the UK and other countries).
- Plea bargaining/prospective sentence mitigation may be a fruitful forum for exploration. In the medium term there might be prospects for taking into account cooperation with research when arriving at disposals/fines/sentencing. (Though care would have to be taken that offenders' responses were not tailored to meet their judgments about researchers' expectations.)
- It would be worthwhile to advertise for cooperation by those who may have found themselves working for short periods in a boiler room or for another illicit operation. Labour turnover may be high in such outfits, just as in many other aspects of telemarketing, and the pool of persons with a tale to tell may be expanding. Some may have left because they did not want to cross a moral or legal line. Consumer fraud journalists are one source of such persons, and may cooperate subject to their informants'/complainants' consent.

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<sup>25</sup> R. Stevenson, 1998, *The Boiler Room and Other Telephone Sales Scams*, University of Illinois Press. We understand that SOCA has been undertaking some prison de-briefings.

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- Finally there is the possibility of research going hand-in-hand with penetration by law enforcement agency personnel (although many problems would need to be addressed). From such a variety of sampling methods, the perspectives of perpetrators both small and large might be obtainable.

Research with victims, resistant parties and perpetrators should have:

(a) an open-ended section (not leading victims, etc, so that they have an opportunity to convey their own perspectives)

(b) followed by a checklist approach (standardised prompts about the *intended* effects of regulation).

That would give a useful indication on the extent to which the FSA could effectively prioritise fraud as general category or parts thereof, which of its powers to bring to bear and, conversely, where its best efforts might be relatively unrewarded (in which cases the FSA could signal to and cooperate with enforcement partners).

### ***3.3.3. To what extent do market risk professionals see frauds as being amenable to FSA control?***

As for market abuse and (later) laundering, specialist market risk professionals with experience of fraud prevention in FSA regulated entities will provide a fruitful source of understanding of the extent of amenability of markets frauds to control by the FSA. Respondents here will include auditors (internal and external), risk and compliance staff, front-line supervisors of bank counter staff (etc) and junior staff in sensitive positions (who may have insights to share that not always carry up the managerial hierarchy).

Market professionals can also usefully comment upon the emerging work with victims, resistant parties and perpetrators, and remaining knowledge gaps. It is common in crime research to round off the sampling with a discussion with law enforcement staff (whilst strictly maintaining confidentiality in respect of the victims, resisters and perpetrators researched). We would recommend adjusting the research design to involve some dialogue with regulatory enforcement staff (including, in respects of boiler rooms, the CoLP Operation Archway team).

The central question for them in relation to frauds, as in relation to laundering and market abuse, is: what is it, if anything, about the various aspects of FSA advice, rule-making, warnings, visits or enforcement that carries a clear fraud-reduction effect? The research approach should be one that focuses on concrete examples of frauds that were and were not detected and (in whole or in part) prevented, and how specific FSA powers and actions were or were not implicated in that outcome.

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### **4. MONEY LAUNDERING – IMPACTS AND AMENABILITY**

Whilst here we focus on money laundering and the FSA role in relation to it, it must be acknowledged that counter-terrorist finance (CTF) and international sanctions against weapons proliferation have been moving up the policy agenda. FSA-regulated entities are or may become subject directly to targeted sanctions of the UN, EU and trading partners, as well as indirectly via the obligation to check that their customers are not on these lists.<sup>26</sup> Both CTF and proliferation finance can be considered in terms of impact and amenability, although we question the utility of doing so in great detail at this time. Conceivably, were one to revisit these topics in future years, one might be talking more centrally about regulators' roles in relation to international proliferation regimes and CTF, with more general anti money laundering measures (in the sense of preventing criminals from enjoying the proceeds of their crimes) being subordinate to anti-proliferation and CTF. However at present, financial criminality, proceeds and laundering in the more restricted and traditional senses are still the main concerns of the FSA, which therefore needs to know about the risks posed by laundering (impacts) and what can be done (amenability).

#### **4.1. What is money laundering?**

In the wake of the collapse of the U.S.S.R., criminal codes were put in place in a number of former Soviet Socialist Republics which mirrored more closely the legal framework and values of the West. Consultants were employed in their drafting. In a meeting between one of these consultants and a very senior government minister in one such republic, the minister, reviewing a provision outlawing money laundering, said (loosely translated): "Let me get this straight: money laundering is where people make money unlawfully elsewhere and bring it to this country and invest it – is that correct?" The answer was in the affirmative. "Why should I be against that?" came the response.<sup>27</sup>

It is not only in the new democracies that the question is asked. In spite of the best endeavours by the UN, FATF, active UK government support for international action, and US compliance with FATF rules that was (rather late in the day) established by the USA Patriot Act, the "why" question still may be heard, *sotto voce*, in major capitals for whom the financial sector is important. One possible answer is a peculiar one: that the international community of states constitutes itself on the basis of agreement on certain prohibitions and tasks, without which international solidarity would not be a going concern.

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<sup>26</sup> FSA, 2008, EU imposes financial sanctions against Bank Melli Iran and its UK subsidiary, 24 June, one page and links.

[http://www.fsa.gov.uk/pages/About/What/financial\\_crime/library/reports/sanctions.shtml](http://www.fsa.gov.uk/pages/About/What/financial_crime/library/reports/sanctions.shtml)

<sup>27</sup> Alldridge, P, 2001, The Moral Limits of the Crime of Money Laundering, Buffalo Criminal Law Review, 5, 1, April, pp 279-319, cited here from pp 302-3.

[http://wings.buffalo.edu/law/bclc/bclarticles/5\(1\)/Alldridge.pdf.pdf](http://wings.buffalo.edu/law/bclc/bclarticles/5(1)/Alldridge.pdf.pdf)

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Regulators face pressures to act on money laundering from a variety of public and private sector sources:<sup>28</sup>

- law enforcement agencies and politicians bothered about ‘transnational organised crime’ and its ability to launder billions of what a senior civil servant termed in an interview ‘mutant capital’;
- corporations (especially American-headquartered ones prohibited from paying bribes to foreign public officials by the Foreign Corrupt Practices Act 1977) campaigning for a legal ‘level playing field’ to that they can avoid losing tenders for contracts to bribe-payers;
- overseas aid agencies troubled by the ‘export’ (aka theft) of funds by Third World potentates (Politically Exposed Persons, in the terminology of international private bankers) into covert individual and corporate accounts held in offshore finance centres;<sup>29</sup> and
- corporations, intelligence and law enforcement agencies, and politicians concerned about terrorist finance both from proceeds of crime *and* from legal-source income.

The main predicate offences and their presumed harms are shown in the table below (taken from Reuter and Truman 2004, their table 3).<sup>30</sup>

Characteristics of Taxonomy of Money-Laundering Predicate Crimes				
	Cash	Scale of Operations	Severity of Harms	Most Affected Populations
Drug dealing	Exclusively	Very large	High	Minority urban groups
Other illegal markets	Mostly	Small to medium	Low to modest	?
White-collar	Mix	Mix	Low to modest	Broad
Bribery and corruption	No	Large	Severe	Developing countries
Terrorism	Mix	Small	Very severe	Broad

On the difficulty of separating out laundering from the predicate offences, Levi and Reuter observe:

Money laundering is difficult to study in part because it is conceptually elusive. Is it a separate activity, like the fencing of stolen goods, or is it better thought of as an element of certain criminal acts, as is conspiracy? There appears to be a disjunction between the legal construct of laundering, which includes acts as modest as the placing of proceeds of crime in a bank account

<sup>28</sup> Levi, M, 2007, Pecunia non olet? The control of money-laundering revisited, in Bovenkerk, F and Levi, M (eds), *The Organized Crime Community: Essays in Honor of Alan A. Block* (studies in organized crime, volume 6), pp 161-182

<sup>29</sup> These may not be in stereotypical tax havens, but major financial centres are all ‘offshore’ to non-residents. There is no space here to go into technical discussions of definitions of ‘offshore’.

<sup>30</sup> Reuter, P and Truman, E, 2004. *Chasing Dirty Money: The Fight against Money Laundering*. Washington, DC: Institute for International Economics.

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in one's own name, and the analytical construct of laundering, which one would expect to mean the sanitizing of proceeds of crime so that one can spend the funds as though they had been acquired legitimately. Most crimes for significant gain generate more funds than their perpetrators can spend in cash in the short term, and storing large sums creates risks from law enforcement and from other criminal predators. In that sense laundering (or at least "hiding," which has become "laundering" through legal extension of the concept) is an integral part of the serious crime process. But how distinct is the process from the commission of the underlying "predicate" crimes?<sup>31</sup>

These are issues that have to some extent been grappled with by the courts.<sup>32</sup>

Having acknowledged these predicate-laundering issues, it is necessary to clarify that we are not here concerned with the predicate acts (with the exception of market abuse and fraud, see chapters above). Nor are we concerned, in this report, with the question of whether anti-laundering controls actually make a contribution to the effectiveness of policing the predicate acts or whether, to the contrary, such controls might constitute a dispersal of efforts. Here and now we are concerned solely with laundering, the predicate acts being 'stripped out' of the analysis, and with question of its impacts and its amenability to control by the FSA. We will employ the same six-point framework of analysis as used above for market abuse and fraud.

### 4.2. Impacts of money laundering

Here we explore some measurement issues, using broadly the same framework as for frauds above (and later also for market abuse).

#### 4.2.1. Are discernable market movements generated by laundering?

Potential macroeconomic consequences of money laundering include, but are not limited to: inexplicable changes in money demand, greater prudential risks to bank soundness, contamination effects on legal financial transactions, and greater volatility of international capital flows and exchange rates due to unanticipated cross-border asset transfers.<sup>33</sup>

That being the case, monitoring of economic data on sectors and markets is a potentially useful tool, as part of the effort to track changes in level and channels of laundering. Historically, successive developments in policy and enforcement have

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<sup>31</sup> Levi, M and Reuter, P, 2006, Money Laundering, in *Crime and Justice* (ed. M. Tonry): Chicago: University Press, pp 289-374, cited at 291-2.

[http://www.publicpolicy.umd.edu/faculty/reuter/Working%20Papers/Levi\\_and\\_Reuter.pdf](http://www.publicpolicy.umd.edu/faculty/reuter/Working%20Papers/Levi_and_Reuter.pdf)

<sup>32</sup> Alldridge op cit, p 293.

[http://wings.buffalo.edu/law/bclc/bclrarticles/5\(1\)/Alldridge.pdf.pdf](http://wings.buffalo.edu/law/bclc/bclrarticles/5(1)/Alldridge.pdf.pdf) . This is an ongoing area of legal flux.

<sup>33</sup> Camdessus, M, 1998, Money Laundering: the Importance of International Countermeasures, Address by Michel Camdessus, Managing Director of the International Monetary Fund, at the Plenary Meeting of the Financial Action Task Force on Money Laundering, February 10, Washington: IMF.

<http://www.imf.org/external/np/speeches/1998/021098.htm>

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provided criminals with motivation for displacement of channels for laundering the proceeds. What twenty years ago was a simple matter of transferring criminal proceeds into bank accounts, turned into an exercise in obscuring the money trails using interbank transfers and layering, and later spilled over into non-bank entities and wider parts of the economy, international trade, derivatives markets and so on.<sup>34</sup>

In response to the realisation that laundering has spilled over into a variety of market channels, researchers have developed methods for finding impacts of money laundering upon broader markets. De Boyrie *et al* (2001) studied monthly sets of import-export data between the US and Switzerland, finding in that data evidence highly suggestive of displacement of laundering into under-invoicing etc. Reporting in marginal journals, and without testing/confirmation by other researchers to date, De Boyrie et al state:

Our analysis has concentrated on the measurement of any possible increase or decrease of capital outflow from Switzerland to the U.S. after the enactment of the Federal Act on The Prevention of Money Laundering in The Financial Sector - Money Laundering Act (MLA) that took place in January of 1998. The results, thus far, show evidence of a significant increase in the amounts of capital outflows out of the country. Empirical tests on the capital outflows support the hypothesis that the enactment of the money laundering law in January of 1998 explains the increased capital outflows during the period of January 1998 and December 1999.<sup>35</sup>

The point for present purposes is not to debate whether changes in policy and/or enforcement may displace some proportion of laundering flows – that is a proposition with which few would have a serious problem. Rather, we focus on the methodologies that may be utilised to track such flows through various markets. Zdanowicz and various collaborators were working with U.S. trade data. Nevertheless, this kind of macro-forensic financial analysis is an ambition rather than an established technique, the results being fragile and the research remaining controversial because the underlying data have multiple interpretations (including clerical errors on some outlier data). This is not a problem when the data are used for investigative purposes, but is very much so when used for aggregate analysis. The point is not so much to critique the trade mis-pricing approach as to caution that its results so far are stimulating but not fully established.<sup>36</sup>

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<sup>34</sup> Quirk, P, 1997, Money Laundering: Muddying the Macroeconomy, Finance and Development, International Monetary Fund, March, 34, 1, quoted at p 8. <http://www.worldbank.org/fandd/english/pdfs/0397/0110397.pdf>

<sup>35</sup> de Boyrie, Maria E., Pak, Simon J. and Zdanowicz, John S., 2001, The Impact of Switzerland's Money Laundering Law on Capital Flows through Abnormal Pricing in International Trade, EFMA 2001 Lugano Meetings, CIBER Working Paper, pp 1-26 and cited here at p 20. <http://ssrn.com/abstract=268444>

<sup>36</sup> Here particularly, and at some other points, the authors draw upon the referee's comments (see also the Preface).

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Similar issues arise in relation to market movements in real estate, where in some countries, both volumes and prices are thought to have risen sharply, due partly to money laundering.<sup>37</sup> Some Spanish markets are said to have received laundered funds, and then collapsed, partly because of over-pricing and partly because of police attention to both laundering and corruption by local and regional public officials.<sup>38</sup> Japan in the 1980s has been cited as a similar case, with the Japanese Yakuza accused of real estate flipping, distorting local financial intermediation by stimulating real estate and stock market bubbles.<sup>39</sup> Whether a similar story could be told of recent housing market movements in the US<sup>40</sup> and the UK is an interesting question. A reservation is that - to our knowledge - there are no Japanese or Spanish studies that estimate with any rigour *how much* of the market instability might be related to financial crime, though corruption, extortion and tax evasion are plainly present in those markets and have influenced control inadequacies.

In summary of the above, models are at various stage of development for analysing laundering flows through various markets including international trade, real estate and financial instruments such as derivatives. Whilst there are problems and work to be done to mitigate them, there seems no reason to exclude these approaches from a composite approach to tracking money laundering through the regulated sectors of the economy.

### **4.2.2. Are complainants generated by laundering?**

The most general answer to this question is that, whilst money laundering may generate some winners and losers, complainants may be few in the 'up' phase. As is widely acknowledged, there will be winners (at least, institutions and individuals perceiving themselves this way), maybe more of them than losers for many years. In what follows we try to identify potential complainants in the early and mid phases of a sector becoming the recipient of laundered money.

The World Bank's 'Reference Guide to Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT)' lists a number of adverse consequences of laundering, in terms of reputational, operational, legal and concentration risks. Included are loss of profitable business, liquidity problems through withdrawal of funds, termination of correspondent banking facilities, investigation costs and fines,

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<sup>37</sup> RICS, 2005, Economic Brief: Money Laundering and Real Estate, in European Alert July, Brussels: RICS Europe. <http://www.rics.org/NR/rdonlyres/CA215D78-4717-468F-A8F2-3B8A9B9C042A/0/1509RicsJuly05.pdf>

<sup>38</sup> Financial Times, 2005, Hot money pays for boom on Spain's Costa del Crime, by Leslie Crawford, March 23. [http://www.ft.com/cms/s/0/448e97a0-9b42-11d9-af0f-00000e2511c8.html?nlick\\_check=1](http://www.ft.com/cms/s/0/448e97a0-9b42-11d9-af0f-00000e2511c8.html?nlick_check=1)

<sup>39</sup> Shibata, Y., 1996, Quaking lenders: how gangsters complicate Japan's banking crisis, *Global Finance*, 10 January, pp 40-41. See also Glenny, M, 2008, *McMafia*, London, Bodley Head.

<sup>40</sup> Black, W, 2007, (Mis)Understanding a Banking Industry in Transition, *Dollars & Sense*, No. 273, p. 14-27, November/December. <http://ssrn.com/abstract=1103942>. In our view, organised crime groups in the conventional sense would be unlikely to have generated these harms in the US or, especially, the UK.

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asset seizures, loan losses and declines in the stock value of financial institutions.<sup>41</sup> Clearly, such a listing combines possibilities of direct losses to specific parties (who may be aware enough to become complainants) with losses that are imposed by policy makers (for example, response costs and sanctions) and therefore are an artefact of reactions to laundering rather than a direct consequence of laundering itself.

As another World Bank paper observes:

Local merchants and businesses may find that they cannot compete with front companies organized to launder and conceal illicit funds. Many such front companies offer their services and goods at below-market rates and even at a loss. Because their primary objective is the laundering of money, they do not need to compete in the marketplace and make a profit for their owners.<sup>42</sup>

The operative word here, however, is 'may'. If the business strategy of the illegal business is to maximise short-term profits and then – in the face of suspicion and possible investigation – to exit, then licit businesses might be forced out. If on the other hand the purpose of the launderer was to integrate into society, not to trigger resentment but to fit in, then only the most stupid would attract attention and hostility by undercutting licit businesses. On the contrary, one might expect a degree of support to established businesses, perhaps low or no-interest loans, favours by way of terms of trade to those in difficulties, or other rather *non-competitive* (decent) behaviour. Thus, in terms of our present interest, there may be few complainants. The World Bank characterisation of ML may be rather too narrow in its analysis.

What these considerations mean is that, in relation to laundering, potential complainants seldom begin to identify themselves as such until too late in the day to be of use in terms of indicating trends in laundering. There are a small number of exceptions, the utility of which to serve as indicators of trends in laundering should be explored.

One exception is competitors, who may see/suspect/resent unfair advantages of other firms or individuals, and so might come forward early enough to be useful. The methodology might look to such persons (informants) and to ways of encouraging them to come forward. The extent to which this might be strategically and culturally appropriate in the view of the FSA is something that we cannot judge.

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<sup>41</sup> Schott, P, no date, Chapter II, Money Laundering Impacts Development, [http://www1.worldbank.org/finance/html/amlcft/docs/Ref\\_Guide\\_EN/v2/02-Ch02\\_EN\\_v2.pdf](http://www1.worldbank.org/finance/html/amlcft/docs/Ref_Guide_EN/v2/02-Ch02_EN_v2.pdf), from the Reference Guide to Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT), World Bank and International Monetary Fund, various paging and cited here from p II-4.

<sup>42</sup> World Bank, no date, Topic: Anti-Money Laundering. <http://web.worldbank.org/WBSITE/EXTERNAL/WBI/WBIPROGRAMS/PSGLP/0,,contentMDK:20292990~pagePK:64156158~piPK:64152884~theSitePK:461606,00.html>

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Another exception would be whistleblowers inside firms and financial institutions: here the FSA has an established procedure.<sup>43</sup> Whether these reports in aggregate could be used to help to track trends on laundering could be an avenue to explore.

Finally, as a part of this mix, there is 'market talk' (chatter). There are clear reasons to be hesitant in regarding this as indicative of anything real in terms of real trends in the markets – fashions of thought, journalistic focus and changes in political atmosphere can be expected to partially shape 'market talk' and, converse, to leave pools of silence around potentially important issues. Nevertheless, it would be a brave agency and possibly a foolhardy one that resolutely ignored such red flags.

In summary of this section, in terms of 'complainants' about laundering, an impact methodology might look to market competitors, whistle-blowers and more diffuse market talk.

### **4.2.3. Are there indicators of costs of laundering?**

There are many unresolved issues of principle in estimating the costs of money laundering. One set of difficulties concerns the question of the relationship, if any, between laundering (and any costs it imposes) and the predicate crimes (and their costs). If a financial crime (say, a certain type of fraud, or a certain form of market abuse) is first assessed for its impacts, and then that proportion of the proceeds of fraud that are laundered is also considered, then *theoretically* any of the following possibilities could apply.

- The combined impacts (expressed in money terms) could be allocated to the fraud (seeing this as the cause of the laundering) but not recognised under a separate heading of ML.
- The combined impacts could be allocated to the laundering (seeing the fraud as the servant of the ML, the latter being closest to enjoyment).
- Or the two impacts could be considered separately.<sup>44</sup>

Does laundering actually impose costs at all on societies (over and above the costs of its predicates)? Answers to these questions cannot be arrived at on an abstract plane, where different values collide, but have to be understood in relation to specific countries, agencies and policy aims.

Consider for example the question of whether ML criminalises an economy or sector (a serious externality) or, conversely, some strong licit economies may offer criminals a path leading away from the continuation of their past and other potential

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<sup>43</sup> FSA, 2002, Whistleblowing, the FSA & the financial services industry: feedback on CP101 and made text, April, London: FSA, pp 54. <http://www.fsa.gov.uk/pubs/policy/ps101.pdf>. Of course, procedures do not guarantee their own full implementation by those who operate within the system; and as the Madoff and other cases demonstrate, rightly or wrongly, whistleblowers are not always believed.

<sup>44</sup> The one thing that would be totally improper would be both to allocate the ML impacts to the predicate offences and also to consider them under a separate ML heading (that would be double counting).

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predicate crimes and from laundering the proceeds thereof. This issue can be linked to the question of whether laundering is undertaken primarily by or on behalf of criminals who continue to offend or, alternatively, those who are 'retiring'. Thinking of the UK, an (unknown) proportion of the criminal proceeds that are laundered (via the City, real estate, etc) emanates from non-British citizens retiring from criminality and for the future seeking a respectable life, a place in respectable society, quality of life, schooling for family, and so on. In which case, it is arguable that although the ML in question certainly derives from past crimes, a narrow focus on the present and the future might conclude that considered in isolation, the domestic policy positives for the UK might be equal to or higher than the negatives. The possibility of 'forgiveness' for past criminal proceeds (though not for the crimes themselves) raises difficult questions for the current global policy of freezing out criminals from upward socio-economic mobility that has developed over the past two decades. Such tolerance would be politically unacceptable in the international community at the present time.

Because of the difficulties invoked by any serious attempt to work out, for each possible instance of laundering, what if any costs fall upon third parties in the jurisdiction in question, there is tendency amongst some observers to take a short-cut, equating costs of laundering with the actual volumes of laundered money. In other words, £X million laundered equals a cost ('to society', perhaps) of £X million. The apparent simplicity (at least at a conceptual level) of that approach is offset by implausibility (see preceding paragraphs) and by the fact that, at a practical level, it has proved extremely difficult to estimate laundering flows – to which difficulties we shortly turn.

In order to begin to answer the question of the economic harm from laundering, it is necessary to specify both a market context (minimally, the current stage of development of the economy and what stage of the cycle it is in). In a slow or stagnant economy, an acceleration of economic growth by Z percent might be highly welcome (even if there were worries about ML on other grounds). However in an already vibrant and possibly over-heating economy (or sector, like real estate) the same acceleration might produce a bubble, the bursting of which would catch only a small proportion of money launderers but could cause wider damage, as less fleet-footed punters are left holding depreciating assets (arguably the situation now in Spain, if not elsewhere).

Estimates of money laundering flows may be made on direct measures (for example, known money laundering scaled up by a factor of 'x') or may be derived from models; as we shall see, neither provide a royal route to sensible estimations of impacts.

The consensus amongst economists and others attempting the direct measurement route is that adequate data is not available and additionally, the assumptions that have to be made to use the data are not safe ones. If one starts with known (or suspected) cases of ML, then the problem arises in relation to the 'x' mentioned above: by what factor should those cases be scaled up, to arrive at all ML? This

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factor theoretically could be obtained from surveys of victims or complainants, however laundering is typically not accompanied by complaints. So for example Middleton (2008) reports on a small number of solicitors, where their financial flows do not match legal advice or other services rendered and the solicitors were unable to rebut the challenge that the flows were ML. On such a basis, Middleton identifies 'at least £240 million moving through solicitors' hands in the absence of an underlying transaction in which the solicitor is providing legal advice'.<sup>45</sup> To move from this focussed work to an overall estimate of ML, one would have to verify such estimates, scale it up by the unknown factor 'x', and then do the same for all sectors of the economy (whilst bearing in mind that 'x' may be quite different for different sectors). However, 'x' is not knowable (and may vary over time). Though little is known about 'laundering markets', it would be surprising if they did not vary geographically or by size/profitability of firm, though perhaps not clustered in London and Liverpool like those identified MSBs used as laundering vehicles.

As another approach, researchers have sought to go back to the predicate offences (be they financial crimes or other) and to estimate the (i) proceeds thereof and (ii) what proportion of these may be laundered. However, then the same problems of scaling up arise in relation to the predicate offences. One faces additional difficulties of how to arrive at generally-applicable ratios of criminal proceeds to laundering (for each predicate offence, for example drugs, that might lead to some ML in the jurisdiction in question).

Such difficulties previously led some authorities, for example Reuter, to explore estimations of market size from the demand or retail end (e.g., number of drug users and the scale of their consumption). However quite heroic assumptions are then required in order to go from retail market size (demand side) to market structure (supply side), numbers of illegal traders at each 'level' of the market, their typical turnovers, their proceeds and the proportion laundered.

After a decade of such studies, the consensus has emerged that such estimation studies are easier to propose than to carry to completion. It seems highly unlikely that the FSA will be in a position to greatly improve on this work where so many have experienced difficulties, the problems being fundamental ones.

A remaining possibility is that SARs might be useful as an indicator of laundering trends. In theory, SARs in aggregate provide a snapshot of market participants' views of money laundering and adding the sums of the transactions reported could generate an amount *suspected* of being laundered in the reporting sectors. If one could be confident that suspicions were being formed (and reported) in a consistent manner, some degree of confidence could be placed in careful analysis of SARs. However, there are clear issues with data quality and with under- and over-reporting, which have been highlighted in the various reviews of the system over

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<sup>45</sup> Middleton, D, 2008, Lawyers and client accounts: sand through a colander, *Journal of Money Laundering Control*, 11, 1, pp 34-46.

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time.<sup>46</sup> In particular, once an account has been highlighted as suspicious and reported once (or more times), it is unlikely that every transaction through that account will be reported as a SAR, the provisions of the consent regime notwithstanding. An absolute figure of suspected money laundering from SARs seems unobtainable and, until the system can be regarded as being in some form of 'steady state', trends over time must be treated with some scepticism.

To what extent might changes in the levels of filings reflect actual changes in laundering and other illegal activities? In addressing this question we pick up the discussion on real estate and mortgage fraud from chapter 6 above. There are a number of mediating factors, including variation in reporting requirements and/or in the propensity to report (including defensive over-reporting by all or some filers),<sup>47</sup> variations in quality of SAR reports (on one approach to assessment of quality of SARs, see Nallasivan 2006),<sup>48</sup> beside variations in actual laundering. As FinCEN observe:

SARs on mortgage loan fraud increased over 92 percent between 2003 and 2004. The increase in filings may be attributed to an increase in overall mortgage lending concurrent with the decline in interest rates in the 2002-2005 timeframe and a broader awareness of this fraudulent activity.<sup>49</sup>

In other words, the increase is partially a result of reporting changes. Nevertheless FinCEN's figure 2, reproduced overleaf, suggests to us that, after controlling for annual increases in SARs filings, there may have been a real and considerable increase in suspected mortgage fraud from 2002-4, as reported through SARs (ibid). This was the height of the US property boom.

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<sup>46</sup> E.g. Lander, 2006, Review of the Suspicious Activity Reports Regime, and improvements subsequent to this.

<sup>47</sup> Takats, E, 2007, A Theory of 'Crying Wolf': The Economics of Money Laundering Enforcement, IMF Working Paper No. 07/81, April.

<http://papers.ssrn.com/sol3/Delivery.cfm/wp0781.pdf?abstractid=979035&mirid=3>

<sup>48</sup> Nallasivan, S (Srinivasan), 2006, Developing a quality score methodology for financial reporting, masters thesis, Massachusetts: Institute of Technology, pp 85.

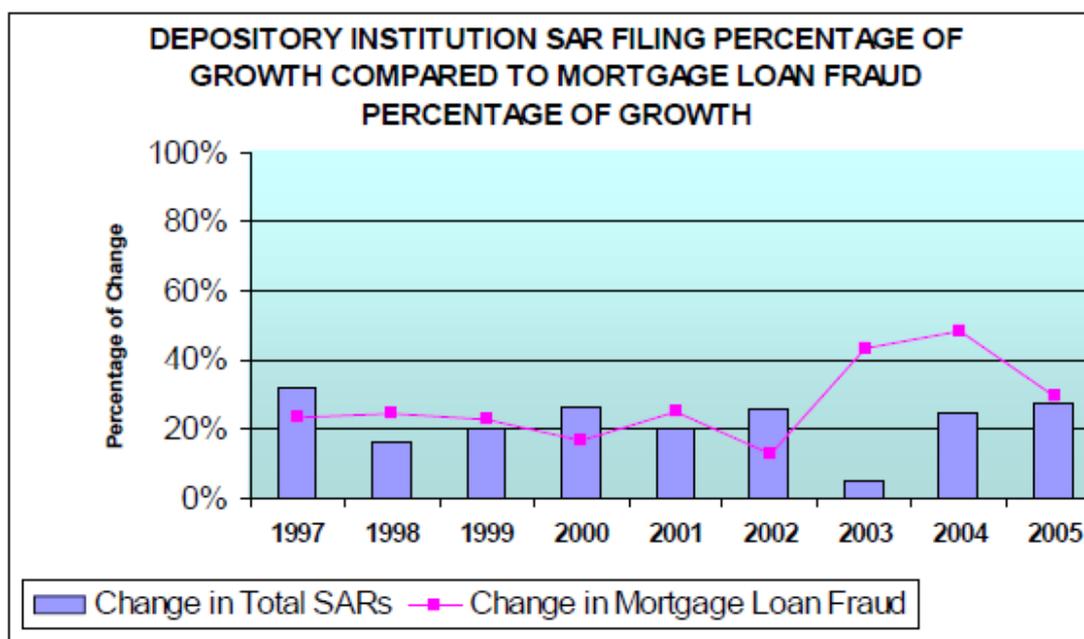
<http://dspace.mit.edu/handle/1721.1/35106> and

<http://dspace.mit.edu/bitstream/1721.1/35106/1/71358342.pdf>

<sup>49</sup> FinCEN, 2006, Mortgage Loan Fraud: An Industry Assessment based upon Suspicious Activity Report Analysis, November, cited at p 2 of pp 21.

[http://www.FinCEN.gov/news\\_room/rp/reports/pdf/MortgageLoanFraud.pdf](http://www.FinCEN.gov/news_room/rp/reports/pdf/MortgageLoanFraud.pdf)

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Source: FinCEN op cit, their figure 2, page 3

In short, SARs may offer a route to tracking trends in money laundering – but only on two conditions, both of which turn out to be not easy to meet.

- The first condition is that efforts are made to filter out 'background noise' caused by changes in reporting dispositions, which are partially driven by changes in reporting obligations and partly by filers' behaviour (for example defensive reporting). The 'raw' SAR data certainly will not do.
- The second condition is that some way is found of estimating the shortfall in high-quality reporting that results from the ever-widening process of displacement of money laundering through channels and markets that either remain unregulated or else are intrinsically difficult, perhaps because of volume turnover (derivatives?) or possibly novel and not yet fully 'on stream' in terms of surveillance.

Further work is needed on both these fronts before SARs could be considered a good source for estimation of trends in laundering. In the meanwhile it remains one of several sources on laundering flows, between which there can be triangulation of estimates. However, *none* of these methodologies translate easily into an estimate of *costs* of laundering, in the sense that estimates of costs of frauds can be at least approached (see preceding chapter).

Our conclusion is that the data on 'costs of money laundering' is not just 'noisy' in a technical sense – more fundamentally, it suffers from definitional indigestion. For all these reasons, such data will no doubt remain of very low quality for some time to come. This underlies the need, when comparing laundering with other financial crimes, not to restrict the analysis to 'costs': other categories of analysis are also needed.

### 4.3. Amenability of money laundering to FSA control

[I]t remains uncertain and seldom asked, whether or not it is harder to practise as an 'organised criminal', a fraudster or a terrorist now compared with 1988, when the UN Vienna Convention and the Basle Committee on Banking Supervision ushered in the Brave New World of seeking on a global basis to control the criminal money trail.<sup>50</sup>

What leverage does regulation have open money laundering, according to 'victims', perpetrators and other market observers? This should be explored through research with the following categories of persons/firms:

- those feeling victimised/disadvantaged
- those who are resistant to being implicated in money laundering
- and launderers (who can give detailed accounts of their amenability to control).

#### ***4.3.1. Who are the victims of money laundering and do they see it as being amenable to FSA measures? Who resists laundering and does FSA action support them?***

Although many may be implicated in money laundering, often unwittingly, few may be directly victimised by money laundering, as we have commented in section 4.2 above. However, competitors of firms whose business size or margins are enhanced by allowing money laundering are indirectly disadvantaged, and their insights could be useful. On the same basis as in anti-cartel actions, competitor firms may be encouraged to give information on one of two possible bases, either through confidential web-based reporting systems or directly, whether they are prepared to be identified to the FSA (but not to others) and wish to give more detailed information.

On sampling, there can be no question of trying to draw a sample representative of all those somehow disadvantaged by money laundering (a conceptually tricky category, in any case). Rather, the objective here is obtaining a variety of viewpoints on amenability of laundering to control by the FSA (and partners). Firms and compliance officers are already strongly encouraged to report suspicions; such reporting is facilitated not only by law but also by commercial considerations and support for a clean market and level playing field; and such sources can be asked about their perceptions of amenability to control. One could do something parallel to the British Crime Survey, the Commercial Victimization Survey, or what the Office of Fair Trading has done on scam victims by surveying all regulated firms. There will remain some difficulty in getting at all individuals or entities who might have been involved but whose involvement as victims or resisters is not known to the person(s) filling in the survey. If the Money Laundering Reporting Officers are included amongst those sampled, this would reduce that problem. One could also make use of professional compliance associations.

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<sup>50</sup> Levi, M, 2007 op cit.

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As for the format of questioning, this should have a descriptive and an analytical aspect. The descriptive aspect would be the generation of three categories of information: numbers and characteristics of specific instances of laundering complained of in detail, stating not only the allegation but also the reasons for which it should be regarded as accurate; numbers of other instances in which the alleged laundering is thought to occur at the target and/or other firms and why; and an invitation to speculate about alternative explanations of what is suspected or observed by the complainant (other than laundering).

Analytically, complainants/victims should be asked what it is about the interaction of the target firms or individuals (launderers) and the regulatory and enforcement environments that allow the laundering to occur. Is the perceived situation one of lack of knowledge or understanding by the firm concerned, or lack of motivation to comply with obligations, or desperation due to financial distress overcoming what might otherwise be dissuasive measures, or insufficient monitoring by the FSA and others?

Exploratory research should also be undertaken to ask persons who have resisted pressures to facilitate money laundering whether their resistance was bolstered by and any aspects FSA regulation and enforcement - or are they resistant for reasons quite unrelated to regulation (e.g. preferred client profile, from morality or just the anticipated reactions of their other clients to crime in general or to particular predicate crimes)? Whistle-blowers, amongst others, can describe both the MO of their co-workers/employers and the reasons for their own resistance (or in some cases desistance). The questions would be similar to those outlined directly above, and again would need to be developed through a feasibility study.

### ***4.3.2. Do perpetrators – money launderers – describe laundering as being amenable to FSA control?***

As in our discussions above of market abuse and frauds, research with perpetrators, where possible, provides one of the best routes to understanding their amenability to control. Money launderers, interviewed as part of a case disposal/plea bargaining process, in prison or after release, can well describe what it is about AML measures in general, and FSA action in particular, that would or would not dissuade them and why. Admittedly there are limitations with such approaches: for example, although there is a well-established research literature based on prison interviews with drug and people traffickers, professional money launderers might be more difficult than drug dealers to find and to interview. They would certainly be reticent to talk about asset holdings or their own laundering activities as compared to discussion of the dealing itself. *However*, such enquires are not being proposed here – rather the objective would be to ask to what extent specific actions by the FSA would impede laundering. Given the low numbers of convictions for money laundering (especially for third party laundering, as contrasted with self-laundering), and the aims of the research, the sampling universe could be all persons recently convicted of a serious or organised crime likely to require laundering (or the services of a specialist launderer). Thus, interviews should cover both professional launderers and persons

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whose expertise and focus is on predicate offences but have laundered their funds. Informants with knowledge of the criminal market in laundering are a closely related source.

The detail attainable through this route would compensate for the limited numbers of interviewees that might be available in the early years. Placed alongside the data from work with complainants (indirect victims) and whistle-blowers, a picture of the amenability of this crime to regulatory efforts would emerge, even if elapsed time from recent offences to imprisonment is too long for this to give up-to-the-moment information on current techniques.<sup>51</sup>

### **4.3.3. Do risk professionals describe laundering as being amenable to FSA control?**

As is well known and much commented on in the literature, there is much scepticism in market circles over whether anti-laundering measures have any deterrent effects on the volume of laundering overall. This may not matter that much to many compliance professionals: their aim is to avoid their institution (and themselves personally) becoming liable for the regulatory and penal sanctions attached to *identified* laundering which has not been reported as a SAR and received consent. However, that scepticism is bound up with concern over the costs of the measures; worries over loss of market competitiveness (New York versus London versus Dubai, etc); and also political and economic arguments against regulation, whether in general or, more commonly nowadays, in particular business and professional sectors.<sup>52</sup> What is needed in interviews with compliance officers and other risk market professionals is focussed reflection on concrete cases of laundering or attempted laundering when AML measures did or did not make a difference to criminals' conduct and to their apprehension or that of their funds. In other words, case studies from the everyday experiences of market participants.

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<sup>51</sup> Research on money-laundering currently is not adequate to enable us to tell how much techniques vary over time.

<sup>52</sup> Some examples of these concerns can also be seen in the lively debate over market failure analysis, mentioned briefly and referenced in Chapter 2 above.

### **5. MARKET ABUSE – IMPACTS AND AMENABILITY**

#### **5.1. What is market abuse?**

Market abuse, consisting of insider dealing or market manipulation, describes ‘circumstances where investors have been unreasonably disadvantaged by others. It prevents full and proper market transparency and undermines market integrity and investor confidence’ (FSA 2003).

#### **5.2. Impacts of market abuse**

##### ***5.2.1. Are discernable market movements generated?***

The measurement (or rather estimation) of the impacts of market abuse first was attempted for the UK by the FSA in 2006 (Dubow and Monteiro 2006).<sup>53</sup> A further study (Monteiro *et al* 2007)<sup>54</sup> refined the methodology, taking on a range of comments offered on the first study. The results focus primarily on price movements prior to the official release of market sensitive information including takeover announcements; volumes of transactions are regarded as supplementary evidence (for reasons, see the two reports). The main findings are that there is evidence of changes in both prices and volumes that are strongly suggestive of trading by ‘informed’ traders; that for takeovers, such changes occurred before and after the FSA was granted powers and began to use them; but for other sensitive announcements, there was a drop, after the FSA started enforcement, in unexpected price movements in shares of the companies concerned.

In broad brush, the refined 2007 methodology paints a similar picture to that of the 2006 (OP23) report. On these data, there appear to be two phases of reductions in insider trading around significant announcements by FTSE 350 companies – (i) after FSMA, (ii) after enforcement action by the FSA, 2004/5. A possibility entertained by the authors of the data (Monteiro *et al* 2007 p 20), suggested to them by market participants, is that:

for more liquid FTSE 350 stocks, prices tend to be more stable, there is an increasing amount of automatic trading and there is more scope to trade on inside information using other instruments e.g. contracts for difference (CFDs). It was suggested that these factors may contribute to a weaker link between insider trading and equity prices, allowing insiders to more easily disguise their trades and minimize their impact on prices. We have, however, no evidence that this is actually happening or about the mechanisms through which this would happen. Hence, these hypothesis remains to be formally tested.

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<sup>53</sup> Dubow, B and Monteiro, N, 2006, Measuring market cleanliness, London: FSA, pp 40.

<sup>54</sup> Monteiro, N, Zaman, Q and Leitterstorf, S, 2007, Updated Measurement of Market Cleanliness, Occasional Paper Series 25, London: FSA, pp 64.

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The hypothesis is a good one from a criminological point of view, in the sense that, typically, persons benefiting from crime tend to adjust their behaviour, wherever possible, not just in relation to expected rewards but also in response to the expectations about the probability and severity (in relation to their own values) of sanctions – be those sanctions reputational (before the FSA started enforcement) or both reputational and financial (post-FSA general enforcement). This is in line with behavioural economics insights that we are influenced more by the desire to avoid downward mobility than by positive incentives as normally defined. Such adjustments are not always in the direction of a reduction in offending: indeed reactions are likely to include so-called criminal displacement, that is to say using different *modi operandi* (MO) for getting similar outcomes. Unless the alternative market instruments are (a) under surveillance equal in intensity to equity markets and (b) equally enforced, then displacement should be the first hypothesis; and the fact that market participants themselves suggest some likely MO adds weight. In this context the authors' disclaimer of 'no evidence that this is actually happening' does not offer adequate reassurance.

In general, from the point of view of a methodology for estimating a level of magnitude of, and changes in, 'insider dealing', these approaches to market monitoring appear to hold considerable promise, on one condition: that they can be extended to adjacent and/or related market sectors or instruments, through which displacement can be expected to occur in relation to any stepping up of surveillance or enforcement by the FSA. This is a good example of what we consider to be an analytically defensible, dynamic and empirically-based model of market distortions due to criminal conduct. It is a particular form of impact, to be placed upon other forms.<sup>55</sup>

### **5.2.2. Are complainants generated by market abuse?**

The answer must be "not always", especially if the notion of complainant is drawn in a restrictive way. Many, possibly the majority, of those directly disadvantaged (or suspecting that they may have been) may be unlikely to complain. Some of those who suspect or know of market abuse, but are not personally directly disadvantaged, may discuss the possibility of market abuse with their professional contacts and even with journalists ('market rumour'). This falls well short of posing their observations in terms of a complaint, let alone a formal one to the FSA. Anonymous allegations, where there is a procedure for making them, may be more likely.

Market participants handling suspicious transactions are, of course, obliged to report them under the terms of both anti-money laundering legislation and the Market

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<sup>55</sup> A (sub-)indicator concerned with market distortion need carry no assumption about harm or costs to individuals (for which see 3.2.3. below). Financial benefits to market insiders are not specified, and unless we simply assume that there are corresponding costs which we label 'harms', the harms cannot readily be compared with those to other financial crime victims, since the specification of the people or firms on which they fall is not self-evident. This has been a controversial area for criminalisation/decriminalisation advocates for decades, both on harm and pragmatic enforcement grounds.

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Abuse Directive arrangements. The level of such reporting is low compared to the level of market abuse suggested by the studies above.

Thus, in order to capture the broadest possible information base of information for strategic (as distinct from operational) intelligence, it would be necessary to construe the category of 'complainants' in a proactive manner, putting in place a process or series of processes for collecting information from market participants, in addition to STR reporting. This should be open equally to those strongly disadvantaged by market abuse, those suspecting they had been lightly fleeced and those who felt themselves to be unaffected yet had some suspicions to impart.<sup>56</sup> It should offer anonymity as an option (and probably as the default option, with the possibility for information-givers to opt out of anonymity if they are willing so to do). Should an approach would not only maximise information flow from those with most reason to feel aggrieved (yet who might fear the consequences of speaking openly); it would also capture wider 'market talk'.

### **5.2.3. Are there indications of costs of market abuse?**

This is one of the most difficult questions of all those dealt with in this report. The difficulty underlines the need to consider costs of market abuse as just one of three sets of information about impacts, alongside market distortions and complainants (above). What costs arise (if any) must depend on resolutions of some contested questions and definitional issues.

A starting observation is that, if the scope of market abuse is as indicated in the market cleanliness work (cited above in 5.2.1), if the direct costs to market participants could be taken as being equal to the gains of 'insiders' or manipulators, and if both these sums are the same as the Cumulative Abnormal Returns (observed returns versus expected returns for the stocks in question<sup>57</sup>), then a first estimate of the aggregate costs of 'all' market abuse in a defined period could be made from the data on 'abnormal returns'.<sup>58</sup>

Another issue in determining costs is the question of how wide a spectrum of 'collateral damage' should be included as costs. Take for example the Hamanaka-Sumitomo manipulation of the copper market. Mr Hamanaka 'squeezed' the market through trades on the London Metal Exchange from 1991 through 1995.<sup>59</sup> Sumitomo

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<sup>56</sup> Here we are taking care not to cut across the FSA's existing arrangements for whistleblowers, a slightly different yet complementary category.

<sup>57</sup> 'Identifying abnormal returns therefore requires us to define what expected returns are. For the FTSE350 analysis, we calculate the expected return by estimating a statistical relationship between the stock and the market return, using daily data on the stock return and the FTSE350 return over an estimation window of 240 trading days ending ten days before the announcement' (FSA 2007 cleanliness study op cit).

<sup>58</sup> Subject to technical difficulties in the use of the market cleanliness data that are beyond the scope of this report.

<sup>59</sup> Gilbert, C, 1997, Manipulation of Metals Futures: Lessons from Sumitomo, London: Centre for Economic Policy Research (CEPR). Purchasable at <http://www.cepr.org/pubs/new->

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eventually lost a lot of money and hedge funds made a lot of money, through an attack on the inflated copper price<sup>60</sup>. However, no doubt many other market participants were adversely affected, first by the 'squeeze' (if they were consumers of copper) and/or by the rapid price fall (if they had hedged forward as a response to tight market conditions). Should their costs somehow be calculated – and should the profits made by others be subtracted from those costs – or should all such transfers be treated as neutral? Was the firm Sumitomo itself a victim (a question that recurs in more recent 'rogue trader' scenarios such as Société General)?

In short, costs of market abuse may be conceptualised in relation to the particular parties who are disadvantaged, some work needing to be done to refine the available picture of who they are.

### 5.3. Amenability of market abuse to FSA control

What leverage does regulation have in practice in relation to market abuse? Following the comparative model developed throughout this report, this question can be explored through research with the following categories of persons/firms:

- those feeling victimised/disadvantaged (greatly or mildly) and those who are resistant to market abuse (defined below)
- perpetrators (including in future plea-bargainers, see chapter 2 above)
- risk professionals in the relevant firms who are positions of responsibility for compliance and risk-mitigation.

#### ***5.3.1. Do victims of market abuse and/or those resistant to it see it as being amenable to FSA measures?***

Those on the losing side of trades marked by market abuse may not often come forward as complainants (see section 5.2.2 above), however such losers, if sensitively approached, may be able to offer information on the extent to which FSA powers and actions did or did not mitigate their losses, and why. Similarly with resistant individuals and entities – including those who managed to 'see it coming' and squared their positions so as to avoid getting hurt, whilst not going so far as to profit through collusion.

Methods for identifying such persons would be through networks, asking those who do complain of market abuse how many other persons/entities they suspect or know also to have suffered. Another approach would be intermediaries or brokers, who may know (or believe) that some of their clients have suffered from market abuse, as they were subsequently confided in by them. From such sources, subject to reassurances about professional confidentiality, we could draw samples of victims and resistant persons and ask them in what respects and to what extent the FSA's regulation of market abuse is effective.

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[dps/dplist.asp?dpno=1537](https://dps/dplist.asp?dpno=1537) or freely downloadable draft at [http://grade.unitn.it/people/gilbert/file/Attachment\\_23.PDF](http://grade.unitn.it/people/gilbert/file/Attachment_23.PDF)

<sup>60</sup> Gilbert op cit pp 1-2.

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### **5.3.2. Do perpetrators describe market abuse as being amenable to control by FSA?**

In many ways this would be the potentially most rich source of data on how amenable certain categories of market abuse are to FSA (and other agencies') principles, rules, preventative activities and enforcement actions. The classic criminological research on perpetrators was helpful in generating much of the 'opportunity theory' and 'situational prevention' strategies that are nowadays mainstream in much of crime control – researchers walking round housing estates with burglars and discussing vulnerabilities of houses to burglary was one of the starting points. Similar approaches are well known in studies of the amenability of 'organised crime' to control by law enforcement and by administrative actions.<sup>61</sup> This broad approach should most definitely be part of the FSA's approach to understanding the leverage and limitations of its activities concerning market abuse, as this moves up the political agenda. Already some potential interviewees would be available – identifiable as a result of enforcement actions, some of whom would see cooperation as part of a post-adjudication/sentencing package of reform and rehabilitation – and the prospect of plea bargaining/sanction mitigation for this offence would generate some further opportunities if those charged with enforcement were able to demonstrate a linkage with abuse to the required level of proof.<sup>62</sup> This could also be an area in which evidence could be drawn from other jurisdictions, in which larger numbers of captured perpetrators have become available for research, such as the US; intra-EU research cooperation and analysis also offers possibilities. However a start could also be made to small-scale qualitative and in-depth research within the UK.

### **5.3.3. Do risk professionals describe market abuse as being amenable to control by FSA?**

The FSA already conducts routine soundings with a wide range of market participants and specialists, including risk and compliance professionals, who are in a position to monitor and prevent market abuse, asking to what extent FSA action prevents and deters financial crime. FSA enforcement can involve withdrawing a firm's authorisation; disciplining authorised firms and people approved by the FSA to work in those firms; imposing penalties for market abuse; applying to the Court for injunction and restitution orders; and prosecuting various offences.

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<sup>61</sup> See, e.g. Felson, M. (2006) *The Ecosystem for Organized Crime*, HEUNI Paper 26, Helsinki, The European Institute for Crime Prevention and Control; Levi, M. and Maguire, M. (2004) 'Reducing and preventing organised crime: An evidence-based critique', *Crime, Law and Social Change*, 41/5: 397-469; Levi, M. and Smith, A. (2002) *A Comparative Analysis of Organised Crime Conspiracy Legislation and Practice and their Relevance to England and Wales*, Online Report 17/02, London: Home Office; Bunt, H. van de and Schoot, C. van der (2003) *Prevention of Organised Crime: a Situational Approach*, (Cullompton: Willan, 2003), and Schoot, C. van der *Organised Crime Prevention in the Netherlands*, [https://ep.eur.nl/bitstream/1765/7385/1/manuscript\\_proefschrift\\_cathelijne\\_4\\_december\\_2005\\_bla\\_dwijze.pdf](https://ep.eur.nl/bitstream/1765/7385/1/manuscript_proefschrift_cathelijne_4_december_2005_bla_dwijze.pdf)

<sup>62</sup> It is a policy decision whether the benefits of using such informants against others (and to gather insights about general market practices) are worth the social costs of granting lighter sanctions.

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Which of these actions (when seriously pursued) deters market abuse, which not and why? Interviews with market professionals, alongside similar interviews with perpetrators, resistant entities/persons and victims, will give insights into the amenability of this crime. What we recommend is the bringing together of these soundings and intelligence-gathering, in a format that *compares* market professionals' observations on the amenability of market abuse with their observations on the amenabilities of financial frauds and money laundering. It would be sensible and useful to introduce an independent element in such work.

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### **6. CONCLUDING THOUGHTS**

#### **6.1. A general framework for information management**

This report envisages and outlines methodologies for impacts and amenability for the three main 'branches' of crime that are of concern to the FSA – frauds, money laundering and market abuse.

The approach advanced involves asking six questions, three of which concern impacts and three amenability. The questions relating to impacts comprise:

- are discernable market movements generated?
- are complainants generated? and
- are there other impact indicators?

The three questions concerning amenability are:

- to what extent do victims perceive financial crime generally, or particular forms of it, as being amenable to FSA measures?
- to what extent do resistant persons describe it as amenable to FSA measures? and
- to what extent do perpetrators do so?

#### **6.2. Improving impact and amenability models and data - the way forward**

We here give some consideration to the best next steps for this Project, which will need to develop the methodologies required by the FSA, recognising that development and collection of data as suggested in this report will require significant investment of resources and time.

##### ***6.2.1. Focus on and comparing specific crime types***

In considering next steps, the FSA Project Board has debated with the study team the issue of practical ways to develop the work programme.<sup>63</sup> The alternatives are:

- (i) empirical work in relation to one particular crime type (for example, a certain type of fraud), looking at it in terms of all aspects of impact and amenability; or
  - (ii) comparing several crime types in terms of all aspects of impacts and amenability;
- or

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<sup>63</sup> The Statement of Requirements for this Project specifically excludes market abuse, but asks that the concepts and methodologies developed should be capable of application to market abuse. Thus, in our practical recommendations for the Financial Crime and Intelligence Division, we focus on financial fraud and money laundering, but (as demonstrated in preceding chapters) the concepts of amenability and impact could, and should, be extended to market abuse, building on the work already carried out by the FSA Markets Division.

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(iii) comparative work, across many different crime types, but in relation to just one aspect (or some aspects) of impact or amenability.

The first option would give a substantive focus to development work. However it would not be very suitable as a demonstration of comparative work – across crime types – that we take to be at the heart of the requirement for the scale and impact project.

The second option above would take the FSA to the end-goal: comparing all or most financial crime types in terms of impacts and amenabilities. That however would be too ambitious for the immediate next steps, and might be delayed whilst the FSA explores the practicality and acceptability of the approach.

Thus, the best option for the immediate next steps is (iii) above: the FSA should consider taking one or more aspects of either impact or amenability and applying them in developmental work *across diverse crime types*. Although this would not give a rounded picture of any one crime type, it would point to the comparative purpose of the methodology.

Which aspects of impacts and/or amenability should be taken up for immediate development work? Which of the following should first be developed?

- Market movement/distortion indicators of impact across crime types
- Complainant-based indicators of impact across crime types
- Direct cost indicators of impact across crime types
- Victim- and resistant person-based indicators of amenability across crime types
- Perpetrator-based indicators of amenability across crime types
- Market participant-based indicators of amenability across crime types.

Our recommendation is based on three criteria, which we find reasonable.

(1) The FSA should tackle the most intellectually and methodologically challenging aspects early on, lest these forever languish. This may mean no quick and easy wins; but on the other hand it lays the basis for a solid and defensible long-term programme.

(2) The FSA should seek to leverage its existing in-house skills and expertise as much as possible. This means, for example, making use of skills sets on analysis of market distortions (as an element of impacts), and consulting more with market participants (on amenability).

(3) The FSA should not prioritise research that is already receiving some attention by UK partners (for example, the costs of fraud work,<sup>64</sup> see earlier sections of this

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<sup>64</sup> Subsequent to our research and draft report, the National Fraud Authority has appropriately taken on responsibility for fraud measurement.

## Impacts of Financial Crime and Amenability to Control by the FSA

report). Such work should be done in collaboration with partners, not by the FSA alone.

Given those criteria, and the exclusion of market abuse from the SoR for this Project, for action in the near future the FSA may want to consider:

- exploring if and how work on market movements/distortions could be developed in relation to financial frauds and/or money laundering (see 6.2.2 below); and
- developing amenability indicators based on the practical experiences of victims, resistant persons and perpetrators, across financial frauds and/or money laundering (see 6.2.3).

### **6.2.2. Improving impact data**

Sources of impact data reviewed here concern:

- (a) market movements/distortions due to financial crimes
- (b) the emergence of complainants, and
- (c) measures of direct costs (not of response costs, for reasons discussed at the start of this report).

Improvement of the first source must fall primarily to the FSA, given its competences and existing investments in measurement through the market cleanliness work. In relation to the others, the FSA will remain a consumer of work carried out elsewhere. The interests of the Financial Crime and Intelligence Division include having access to such data, being able to understand the level of quality it offers and its limitations, and being able to check back with the data generators concerning any interpretations that the FSA might wish to make of that data in relation to impact analyses.

*With regard to the next steps in research of impacts, there is a need for data on market distortion, and the Financial Crime and Intelligence Division may want to communicate such interests to colleagues working within the FSA on market cleanliness in relation to market abuse. As and where appropriate, attempts should be made to develop such methods in relation to market distortions caused by major frauds (or by extensive low-level frauds, such as widespread mortgage fraud) and in relation to money laundering. It would also be useful for the FSA to commission internal or external exploratory work and piloting in these areas.*

In relation to complainants, data are generated both by the FSA (though its standard monitoring, complaint and whistle-blowing systems) and by partners.<sup>65</sup> Here the information strategy of the Financial Crime and Intelligence Division should be to designate itself as a customer for data that exists or is in course of being generated,

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<sup>65</sup> A non-exhaustive list would include the Office of Fair Trading, the police (albeit rarely for some categories of financial crime), the SFO, the new structures of the National Fraud Authority and its measurement unit, the National Fraud Reporting Centre, the National Lead Force for Fraud and SOCA (especially in relation to intelligence concerning laundering)

## **Impacts of Financial Crime and Amenability to Control by the FSA**

to communicate its interest to partners in relation to any new work planned and potentially (when a strong need is clearly defined, see paragraphs above) to co-commission.

In relation to (iii), the measurement of direct costs, the FSA shares an interest in research carried out by other UK agencies, the Home Office and sometimes by the private sector (business crime surveys). There have been several attempts to draw together data on the costs of frauds in and against the UK, although sometimes in such work the authors have not been primarily concerned to delineate the parameters of financial crimes of central concern to the FSA (see chapter 3 above). The ACPO study was not tasked with working out which frauds were relevant to which criminal and regulatory bodies. Here the strategy of the FSA should be to communicate its areas of interest effectively to survey designers, data analysis and authors of (meta)reviews, so that costs data of interest to the FSA are clearly specified and generated. Co-commissioning may sometimes be appropriate.

*With regard to next steps in these areas the FSA may want to set up a small project, in-house or externally, to contact all government bodies and private sector firms potentially interested in commissioning crime costs estimates over the next few years, communicating the FSA's interests.*

### **6.2.3. Improving amenability data**

The proposed three sources for data on amenability of financial crimes to FSA control are the focussed experiences of:

- (a) persons and entities that have fallen victim to financial crimes and those have been resistant to attempts;
- (b) perpetrators; and
- (c) experienced risk professionals.

In relation to (a), some data exist in administrative systems and in specialised survey work (for example, the Office of Fair Trading 'scambuster' work noted above). However, such data generally do not explore in any detail the extent to which FSA (or other) powers and actions protected the victim. Nor do such sources reveal much about targeted persons' resistance to financial crimes i.e. whether and in what extent such resistance is bolstered by FSA activities. There is a large area of work to be opened up here and the methods for doing so are established social or market research methods, allowing for due sensitivity in identification and approaches to victims and resistant persons.

*One option for taking work forward in this area is for the FSA to undertake or procure qualitative research on the experiences of regulated persons and their customers targeted by financial criminals. Such research would examine which, if any, powers and activities of the FSA are seen as having been neutral, supportive of their resistance (albeit incompletely in the case of victims) or counterproductive.*

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*The sample of persons should aim to cover both victims (including repeat victims), those who were resistant to all approaches by fraudsters and those who were victims on at least one occasion and resistant on at least another. This qualitative research should have as its objectives the generation of preliminary information and the design of further, quantitative work.*

### 6.3. Summing up

In conclusion, this report, together with the literature survey by Fleming, shows that at least some of the methodologies required to compare the impacts and amenability to control of different financial crime types are known in principle. The knowledge gap can and should be addressed in a planned and progressive manner, by the FSA,<sup>66</sup> the National Fraud Authority, SOCA and/or other public and private sector partners in the UK and, potentially, internationally.

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<sup>66</sup> Methodologies suggested in this report can be used alongside ex ante and ex post analysis tools already used by the FSA, such as impact analysis, stand-alone cost-benefit analysis, and compliance analysis frameworks.



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