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1 Introduction

Tackling money laundering in the European Union has become more urgent in the wake of the US Treasury Department's targeting of ABLV Bank in Latvia in February 2018, and following a number of other high-pro le cases of con rmed or alleged money laundering in large and small EU countries (Annex 1), and the 2015-16 disclosure of the so-called Panama Papers[1]

We start in the next section by briefly outlining the general features of AML policy, before summarising the current supervisory arrangements and ongoing policy developments in the EU (section 3). Section 4 describes the AML supervisory framework in the United States, which is doubly relevant to the EU debate, as both a significant comparison point and as a

Global standards for AML regimes were rst formulated in 1989 following the creation of the Financial Action Task Force (FATF) at the G7 Summit in Paris[13]. Since then, FATF has set out 40 standards ('recommendations') that cover AML rules for nancial and other entities to be enforced by public authorities, the proper criminalisation and prosecution of money laundering, the creation of nancial intelligence units and transparency steps such as the availability of information about the bene cial owners of legal entities and arrangements such as trusts[14]. FATF has 35 member countries, including the 15 pre-2004 EU member states, plus two regional members, the European Commission and the Gulf-Co-operation Council. Most of the world's other jurisdictions are members of nine FATF-Style Regional Bodies (FSRBs), such as MONEYVAL for (mostly) eastern Europe, which includes the other 13 EU countries[15]. FATF and the FSRBs organise mutual evaluations of their member jurisdictions for compliance with FATF recommendations. FATF also implements a process to identify jurisdictions with strategic AML (or CFT) de ciencies (greylisting) or those whose failure to address such de ciencies is ongoing and might require action by other members (blacklisting)[16].

e e orts of individual jurisdictions to combat money laundering rest on three pillars:

- [illegible] AML supervisors. AML supervisors examine entities for adherence to the jurisdiction's AML regime and typically have the power to impose nes for non-compliance. ese entities include banks and other nancial rms but can also include casinos, precious metals dealers and – in the European Union – art dealers, lawyers and accountants. e United States puts less emphasis than the European Union on AML supervision of non- nancial rms (see section 4). Correspondingly, the scope of entities subject to AML supervision is often referred to as *"covered nancial institutions"* in the United States, while the European Union uses the broader expression *"obliged entities"*. As a result, several sector-speci c AML supervisors coexist in most, though not all, jurisdictions[17]. In accordance with FATF recommendations, most AML regimes require obliged entities to maintain a risk-based AML programme, meaning the extent of surveillance and controls over activity at the institution should be commensurate with the risk pro les of the various clients and lines of business. Such programmes oblige these entities to identify and perform due diligence on their customers, conduct transaction monitoring, retain and produce certain records and le suspicious activity reports[18].

  For obliged entities that are also subject to a prudential supervision regime, such as

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Security and Oxfam, 2015). Others have criticised contemporary AML for in effect passing on policing responsibilities to financial institutions. However, we take the framework as it is and do not attempt to address those fundamental critiques, focusing instead on how the EU can improve its framework.

3 Current supervisory framework and AML policy developments in the EU

Ten years ago, the EU financial services (including AML) policy framework consisted of legislation that was partly harmonised at EU level and enforced almost exclusively at national level. This landscape has undergone radical changes in the past decade. The resulting structure is extremely complex, with an awkward coexistence of national and supranational features, many new and untested aspects, and widespread expectations of more change to come in the near future. Box 1 gives an overview of the structure of EU financial regulation and supervision.

Box 1: EU financial legislation, regulation and supervision

EU laws can be 'directives', framework laws that demand additional legislation ('transposition') in each member state, or 'regulations' – laws that are directly applicable in all member states with no need for national transposition. 'Maximum harmonisation', or the establishment of identical legislative arrangements in all EU countries (as opposed to minimum standards or 'minimum harmonisation'), is most easily achieved through regulations, even though these might also leave flexibility to member states on how to implement them. In terms of financial services laws, most (though not all[22]) EU directives and regulations are based on Article 114 of the Treaty on the Functioning of the European Union (TFEU), which forms the basis for all European single market laws. Such laws are always initially proposed by the European Commission, then negotiated by the Council of the EU (composed of representatives from all member states) and the European Parliament (whose members are elected by universal suffrage to a five-year term)[23]. Confusingly, what are known in the United States (and in many EU member states) as regulations, ie rules issued by administrative agencies under a general framework established by laws, are referred to as 'binding technical standards' when issued at the EU level, typically by the European Commission upon the proposal of the relevant European supervisory authority[24].

The 'Single Rulebook' is a non-legal expression that refers to the aim of maximum harmonisation in EU financial services rulemaking, or to the subset of applicable rules which is maximally harmonised. An example of the Single Rulebook is the Capital Requirement Regulation (Regulation No. 575/2013), enacted in 2013 on the basis of the Basel III Accord of 2010,

22 A significant exception is the SSM Regulation of 2013, which is based on Article 127(6) TFEU and had thus to be adopted by unanimous vote of the member states with only a consultative role for the European Parliament.

23 The Council of the EU, or the Council, and the European Parliament are together known in EU-speak as the co-legislators. The Council is not to be confused with the European Council, which refers to meetings of the EU member states' heads of state and government to provide policy direction but without formal involvement in the EU legislative process, or with the Council of Europe, which is a human rights organisation not directly related to the European Union and with a significantly broader geographical scope and membership.

24 An exception is ECB rules that are also known as ECB Regulations. The ESAs also issue documents known as regulatory guidelines and recommendations, which are generally observed by market participants but are not legally binding.

that sets largely uniform capital requirements for banks throughout the European Union with

authority, and (generally smaller) Less Significant Institutions (LSIs), the day-to-day supervision of which remains at the national level. SIs include all banks above €30 billion in total assets, plus others according to certain additional criteria[30]. There were 116 SIs and slightly fewer than 3,000 LSIs as of mid-2018[31]. As of end-2017, SIs represented about 81.5 percent of the system's total assets (ECB, 2018a). Ninety-one of the 116 SIs were banking groups headquartered in the euro area, while the other 25 were euro-area operations of banking groups headquartered elsewhere[32].

For SIs, while the ECB has sole prudential supervisory authority, relevant national agencies, referred to as National Competent Authorities (NCAs)[33], also participate in the process through Joint Supervisory Teams (JSTs). A JST brings together supervisory staff at the ECB in Frankfurt (up to a dozen for the largest banks) together with staff from the NCAs of the countries where the supervised banking group has significant operations. The JST is led at the ECB by a JST coordinator (functionally equivalent to a Central Point of Contact in the US Federal Reserve system), while each NCA's staff group within the JST is led by a JST sub-coordinator. The coordinator and sub-coordinators prepare supervisory decisions together; in case of disagreement, the decision proposal is made by the coordinator alone, with mention of the dissenting opinion(s).

For LSIs, day-to-day prudential supervisory decisions are made by the relevant NCA, including setting regulatory requirements, assessing the bank's soundness and vetting of management and supervisory board appointments to ensure that all banks' key deci-

FIUs' Platform, an informal group that supports occasional projects[40]. The European Union's Judicial Cooperation Unit, known as Eurojust and established in 2002, works to coordinate criminal investigations and prosecutions of cross-border crimes in the European Union, including money laundering cases. Eurojust, however, has no autonomous powers to investigate or prosecute.

Recent policy developments

In May 2018, the European Commission initiated joint work on AML reform with the ECB and the three ESAs[41]. The first outcome of this work was a reflection paper sent to member states in late August 2018. This paper has not been made public by the EU institutions, but its text was commented on in the media[42] and later posted online by a member of the European Parliament[43].

On 12 September 2018, in his yearly State of the European Union address, European Commission President Jean-Claude Juncker announced new measures to reinforce the effectiveness of AML enforcement, and the European Commission on the same day published proposals for corresponding amendments to the ESAs Review legislation. If adopted, these amendments would, among other things, confer on the EBA additional authority to request that national AML supervisors investigate potential breaches and consider actions, and in extreme cases of non-compliance by the national authority, to impose some direct decisions (though not fines) on individual firms. It would also empower the EBA to carry out periodic independent reviews of AML issues and risk assessment exercises and to collect data on AML supervision in the European Union (European Commission, 2018). Unlike existing EBA

decisions including the identity of the affected person or entity and the nature of the breach[46], but it is not clear that all member states comply with this requirement, and the deadline for transposition (June 2017) is too recent for a firm assessment. From discussions with practitioners conducted for this paper, the UK FCA appears to have a reputation for imposing higher fines for AML violations than most other national authorities, even as fines are often much higher still in the United States[47]. Among other EU member states, interviewees mention Italy and Germany as imposing very low fines for AML violations, whereas France is somewhere in between. Mutual evaluation reports published by FATF and MONEYVAL provide some qualitative detail but do not allow for a comprehensive comparison of AML enforcement and its effectiveness across EU/EEA member states.

Recent cases for which some information is publicly available are summarised in Annex 1. Many of these events occurred in smaller euro-area countries, where resources for supervisory oversight are typically constrained. There are two important caveats, though, that suggest caution about causality in that observation. First, major money laundering incidents at EU banks have not been limited to smaller jurisdictions and have also occurred in major financial centres such as London. Second, it is intrinsically hard to ascertain whether more publicised cases of prominent money laundering reflect a greater frequency of money laundering in a given jurisdiction, or, conversely, a greater willingness on the part of the jurisdiction's authorities to root out problems and tackle illicit activity – or both.

4 AML in the United States

The AML regime in the United States is based on a body of laws referred to as the Bank Secrecy Act (BSA), which is found in Titles 12 and 31 of the country's code of federal laws (the United States Code or USC) and further implemented via regulations in Title 31 of the Code of Federal Regulations (CFR)[48].

The US Treasury Department has the authority to administer the BSA and delegates that authority to the Financial Crimes Enforcement Network (FinCEN), a bureau within Treasury, by Treasury Order 180-01. FinCEN is both the AML supervisor in the United States – setting rules for financial institutions, providing interpretive guidance and issuing penalties – and the country's FIU, supporting law enforcement and other regulators[49].

As of 2013, FinCEN directly employed approximately 340 people (Shasky Calvery, 2013). Most of these personnel are devoted to its financial intelligence analysis, policymaking and technology functions, rather than to enforcement and supervision.

FinCEN relies on other federal financial supervisors[50], which are much larger organisations and to which FinCEN has delegated its AML supervisory authority, for the efficient examination of most covered financial institutions[51]. With respect to AML supervision of the

46 Article 60 of AMLD4 also has exceptions in case of disproportionate impact or financial stability risk.

47 Very recently, the Dutch central bank has also moved to impose large fines as documented in Annex 1. Article 59 of AMLD4 raised and harmonised the maximum amount of AML fines to [illegible]

banking sector alone, these agencies include the Office of the Comptroller of the Currency (OCC), the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC) and

“that includes closer collaboration between FinCEN and the federal functional regula-

vision of US correspondent accounts, effectively ending their ability to make international payments cleared in dollars. In recent years, FinCEN has targeted banks in three European countries: Andorra, Cyprus and Latvia[61].

5 Challenges and options to improve the EU framework

A broad-based perception has crystallised since the ABLV case erupted in February 2018 that the European Union has an AML problem (see section 1 and Annex 1). A surge of headline-grabbing cases has entrenched the narrative that, in the words of a prominent commentator, *"EU banks have become a money launderer's dream"*[62].

Pinpointing Europe's AML supervisory problem

Given the difficulty of observing and quantifying money laundering, it is not self-evident that malpractice has actually become more widespread in recent years. It is also possible that acceptance of it has decreased. Factors that might have led to heightened AML awareness in Europe include:

- An assertive recent stance from the United States, as illustrated by the ABLV case;
- An erosion of the perception of structural alignment between EU and US interests and a correspondingly rising perception of the need for Europe to develop its own capacity to identify threats and ensure its security;
-

supervision generates national vicious circles, which tend to be self-perpetuating rather than self-correcting[63].

In this 'AML vicious circle' analytical framework, money-laundering and AML violations end up being asymmetrically distributed in the European Union. Some member states become weak links from which clients can be served throughout the entire single market, for those activities for which a passporting regime exists. Not all member states need be weak links for money launderers to achieve their objectives. As long as at least one weak link exists, the entire AML system is at risk of failure. A corollary is that, even if some EU member states have highly e ective AML frameworks, it does not disprove the assessment of the AML problem as systemic and a matter of EU supervisory architecture. Furthermore, it is not enough to eliminate a weak link – even if the vicious circle is broken in one member state, it is likely to reappear in another. Also, not all weak-link countries need be smaller member states. While insu cient administrative capacity may be a more acute problem in very small countries, undue in uence from certain special interests or other forms of institutional failure can a ect larger countries as well. e variety of patterns of de ciencies in AML regimes in the European Union are illustrated in Annex 1.

To be sure, in theory national AML authorities in the other member states check transactions originating in the weak-link countries and should be able to spot suspicious activity. But this can be ine ective in practice, given national authorities' capacity constraints and priorities, and given the dense web of relationships and interdependencies that exist between them within the single market. Furthermore, within the euro/banking union area, any national authority's AML supervisory failure potentially compromises the integrity of the entire prudential supervisory framework (and of the licensing, qualifying holdings and F&P review processes) to the extent that it relies on AML assessments, as ABLV and other cases have shown. Moreover, the likely future development of nancial technology and of new business models for nancial intermediation and services that are inherently cross-border is likely to exacerbate the tension between the single market framework and national AML supervision[64].

Addressing the AML vicious circle: two-tier vs unitary architecture

To deal with the European Union's core AML supervisory problem, the incentives of AML supervisors should be aligned with the objective of e ectively enforcing the AML framework and ghting money laundering throughout the entire single market. Breaking the vicious circle thus requires the introduction of a signi cant element of EU-level supervision, beyond the limited oversight that already exists.

On that basis, the EU faces a choice between two models. In an enhanced two-tier architecture that builds on the present situation, the ultimate responsibility for AML supervision of individual rms would remain at the national level, but an EU authority would be empowered to exercise some form of surveillance over national AML supervisors ('supervisor of supervisors')[65]. In a unitary architecture, a European agency would have ultimate AML supervisory responsibility for rms, though this responsibility might be exercised through a network that involves national agencies and other European-level bodies.

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national[66]

political interference[71]. Once in place, a unitary architecture also reduces the scope for political conflict between European and national authorities in the event of diverging views, which is embedded in any two-tier system.

On the basis of the SSM experience since 2014, the supervisory effectiveness of the European agency under a unitary architecture should be significantly greater than that of the weaker member states' AML supervisors, and not necessarily less than the best current national practice. Conversely, in a two-tier system, even with forceful capacity at the hub, weak links will inevitably remain. As such, even to the extent that an effective two-tier system may be able to spot malpractice, a unitary system is bound to do so at an earlier stage and to be more proactive in taking appropriate action. For similar reasons, a unitary system would be more resilient than a two-tier system against the possibility of erosion of the rule of law in a given member state, even though it would cover only AML supervision and not the FIU and law-enforcement pillars of the AML framework.

A unitary system would also greatly enhance and facilitate the European AML supervisor's cooperation and information-sharing with its counterparts in other jurisdictions, not least the United States. While this would not deprive the US government of its ability to act unilaterally, eg by wielding its authority under Section 311 of the PATRIOT Act (see section 4), it would likely help ensure that the use of such instruments would remain selective, as it appears to have been so far. At the global level, a unitary European architecture would reduce the complexity of FATF processes, as fewer European participants would need to be directly involved.

Conversely, the main advantage of a two-tier architecture is the more incremental nature of the change compared to the status quo. But for it to be effective, the central agency will need to have strong powers in terms of access to information and enforcement capabilities, which ultimately raise similar political challenges as those inherent in a unitary system[72].
On balance, a unitary architecture for AML supervision in the European Union is feasible, simpler than a two-tier system, likely to be significantly more effective, compliant with the principle of subsidiarity and generally preferable.

- EBA for all financial firms or even all obliged entities (Option 3)[73];
- ESMA for all financial firms or even all obliged entities (Option 4);
- A joint venture of the three ESAs, building on the existing AMLC (Option 5);
- A dedicated new agency, which may be referred to as the European AML Authority or EAMLA (Option 6)[74];
- A dedicated new agency with authority over only a subset of member states, established through a process of enhanced cooperation (Option 7).

The following analysis is intended as a preliminary exploration of the main advantages and shortcomings of these options, pending a more comprehensive assessment. Option 7 is only a fall-back option in case all others would lead to political deadlock. This is unlikely to be the case, however, since Options 2-6 can all be implemented through EU single market legislation (on the basis of Article 114 TFEU), which only requires approval by a qualified majority of EU member states[75].

Option 1 has immediate appeal given the generally solid performance of the ECB as a banking supervisor, and it has been mentioned in public by a senior German official[76]. But it also has several drawbacks. Like Option 7, it does not cover the entire single market, leaving space for a continued AML vicious circle affecting countries outside the banking union area. This is a concern in any case, and particularly if, as appears possible at the time of writing, the UK remains in the European single market for an undetermined period of time following its planned exit from the European Union in late March 2019[77].

Moreover, Option 1 would presumably be based on Article 127(6) TFEU, like the SSM, raising challenges of both procedure (unanimity) and legal robustness[78]. Article 127(6) also specifically refers to *"credit institutions and other financial institutions with the exception of insurance undertakings"*, so the sectoral scope beyond banks would be correspondingly limited. Furthermore, adding the AML task to the ECB's already heavy burden of responsibilities might create too much centralisation of authority in a single institution, given the comparatively fragile framework for general-purpose executive authority and democratic scrutiny at the European level[79].

Options 2, 3, 4 and 5 all build on the existing structures of the three ESAs. Option 2 is the most straightforward but has the drawback of entrenching fragmentation of AML supervision along sectoral lines, which the US experience suggests is suboptimal (section 4). The drawbacks of such sectoral fragmentation can be expected to be increasingly significant in the future, as the emergence of new financial technologies might blur the boundaries between

73 This option is hinted at as a long-term outcome by the European Commission Communication of 12 September 2018 (COM(2018) 645). However, the European Commission's legislative proposal of the same day stops short of Option 3, since it entails a two-tier and not a unitary architecture for AML supervision.

74 A variant of Option 6, which we do not here further explore, might be the creation of a dedicated new European Commission directorate-general, modelled on the existing framework for competition policy under the competition directorate-general, which would take over the AML supervisory mandate directly. This would not be functionally very different from a new EU agency, but it would entail a different framework for governance, accountability and funding.

75 In the EU context, 'qualified majority' refers to a specific supermajority of member states defined in the EU treaties. Under the currently applicable Lisbon Treaty, it implies approval by at least 55 percent of member states (16 out of 28) representing at least 65 percent of the EU population.

76 See Alexander Weber, 'Money-Laundering Scandals Prompt EU Rethink on Policing Banks,' [illegible], 2 October 2018, which quotes State Secretary Jörg Kukies from Germany's Federal Finance Ministry.

77 If the UK leaves the single market it will be treated as a third country for AML purposes, as is currently the case with Switzerland.

78 It is not clear that the reference in Article 127(6) TFEU to [illegible] […], [illegible] […] [illegible] can be understood as including AML supervision in addition to the prudential supervisory tasks already conferred on the ECB by the SSM Regulation. It is also not clear that the ECB could be granted an AML supervisory mandate under another treaty article, eg Article 114 TFEU.

79 Similar considerations led in 2012-13 to the decision to build the SRM entirely outside of the ECB, a decision that the ECB supported.

subsectors of finance and correspondingly open new avenues for regulatory arbitrage.

thus creating legitimacy and accountability. e agency's funding should be through a levy directly collected from supervised entities, similar to the funding of the SSM.

e steady-state size of EAMLA sta depends on how much of its supervisory work would be delegated to other bodies – other EU agencies such as the SSM (for banks), or national AML supervisors, or both. EAMLA would need sta for policy work and rule drafting, similarly to the ESAs[83]. For supervisory work, EAMLA could rely on hybrid teams of its own sta

ECB (2018b) 'List of supervised entities – Cut-o date for signi cance decisions: 1 July 2018', European Central Bank, August, available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.list_of_supervised_entities_201807.en.pdf

EU FIUs' Platform (2016) *Mapping Exercise and Gap Analysis on FIU's Powers and Obstacles for Obtaining and Exchanging Information*, 15 December, available at http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&e9u(g)-2 11n3 718.7&no=2 /Span /Lang (en-GB)/MCID 1675 BDC BT0 0 0

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FBME had been the subject of a US Treasury Department action under Section 311 of the PATRIOT Act in 2014[93].

[illegible] (-)

In 2016, the Czech National Bank revoked the license of ERB Bank, which it found lacked a functioning AML system[94].

[illegible] (-)

In 2018, Danish prosecutors announced a new probe into Danske Bank after the bank's publication of an internal report that disclosed that over €200 billion in transactions owed through its Estonian branch over a nine-year period, of which at least 40 percent was potentially suspicious. e Danish Financial Supervisory Authority (FSA) also announced a new investigation, and the bank's CEO resigned[95]. In September 2018, at the European Commission's request, the European Banking Authority (EBA) started a breach-of-Union-law preliminary enquiry into AML supervision of Danske Bank in Denmark and Estonia[96]. In 2017, Danish prosecutors had ned the bank DKK 12.5 gC B Boe1lltc607 (ar (A) s)2 (tar)-7 (t)1 (e)-3 (d a br)15 (e9Tthe C)13 (z)3 m80. (io)3 (d

Annex 2: AML supervisors for banks and Financial Intelligence Units in EU/EEA countries