Testimony[1] of David Albright before the Subcommittee on Terrorism and Illicit Finance of the House Financial Services Committee

Countering the Financial Networks of Weapons Proliferation

July 12, 2018

A mission of the Institute for Science and International Security is to work to prevent the proliferation of weapons of mass destruction and the wherewithal to make them. As part of this mission, since the Institute was founded 25 years ago, we have focused on detecting, understanding, and characterizing the trafficking of commodities that can be used in sensitive weapons programs with an emphasis on nuclear-related commodity trafficking, also known as illicit trade. In addition to dozens of case studies, reports on our website, and books analyzing such illicit procurement schemes, my Institute recently published a report ranking the export control systems of 200 countries, territories, and entities. This report, the *Peddling Peril Index (PPI)*,[2] is the first comprehensive and in-depth ranking of countries' national strategic export controls. In the index, we rank countries based on their capabilities and performance in five areas, which we call super criteria: International Commitment, Legislation, Ability to Monitor and Detect Strategic Trade, Ability to Prevent Proliferation Financing, and Enforcement. Several related publications can be found on the Institute's website.[3]

Preventing proliferation financing, or Financing of Proliferation (FoP), albeit not a traditional component of a review of national export control systems, is one of the most important aspects for detecting and stopping exports of sensitive goods. Our research revealed that countries' ability to prevent proliferation financing is one of the counterproliferation areas most in need of improvement globally and would benefit significantly from a closer integration with export controls.

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[1] This testimony is the collective work of the Institute for Science and International Security, in particular the work of David Albright, Sarah Burkhard, Ramya Ramjee, Naomi Silverstein, and Andrea Stricker.

[2] "How to Obtain the Book," Institute for Science and International Security, http://isis-online.org/ppi/detail/obtain-the-book/

[3] For more information and additional PPI studies, see: http://www.isis-online.org/ppi

Under the super criterion, *Ability to Prevent Proliferation Financing*, the Institute attempted to measure countries' susceptibility to being exploited or involved in FoP, including violations of international sanctions. The methodology we use is outlined in the appendix to this testimony and is contained in the book *Peddling Peril Index 2017*. For this hearing, we have updated our 2017 FoP results on a preliminary basis and included both the results for 2017 and 2018 here. The final 2018 analysis will not be issued until later this year but enough has changed to warrant the inclusion of this preliminary update.

In the Institute's PPI ranking, the proliferation financing super criterion is the one under which countries collectively performed the worst. Moreover, this super criterion offers the fewest sub-criteria for measuring countries' performance because of a lack of available data and public discourse on the topic, including a paucity of organizations that conduct training in countries that need improvement.

To develop a numerical ranking of performance under the super criterion *Ability to Prevent Proliferation Financing*, countries received points based on sub-criteria that assess countries' capabilities to prevent money laundering and FoP. These sub-criteria are based on their financial regulatory systems and counter-illicit financing programs, for which the main source of data for the PPI is the Financial Action Task Force (FATF). In particular, our starting point was FATF's Mutual Evaluation and follow-up reports on countries' compliance with Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT) recommendations. Early in our process, we brought in experts with knowledge of FoP to advise the project on the most effective way to evaluate the FATF-collected data to draw out information relevant to an evaluation of proliferation financing. To supplement the FATF data, the evaluation utilizes additional measures and information relevant to judging a country's ability to prevent proliferation financing, such as estimates about the size of a country's black market or the extent of corruption.

Results

A central conclusion is that most countries do not perform well on preventing proliferation financing. In the ranking of this super criterion in 2017, no country achieved two-thirds of the available points and only two received more than half the available points. Many countries perform poorly due to having excessive bank secrecy, providing tax havens, and being places where front companies find it easier to finance nefarious activities. Other countries simply lack regulations and effective institutions.

Iran performs particularly poorly in the PPI, including on proliferation financing where it ranked at the bottom. Iran has been given extended time to fulfill its Action Plan requirements set out by the FATF and to comply with FATF standards. Recent actions have confirmed the deep involvement of Iran's financial system in illicit activities. As a result, we recommend the re-imposition of FATF counter-measures against Iran.

The pie chart in figure 1 shows the fraction of countries that have scores exceeding 50 percent of the total, between 50 percent and 25 percent of the total, less than 25 percent down to a score of 0, and below a score of 0. Only two countries received more than half of the available points. About one-third of all countries achieved negative scores.

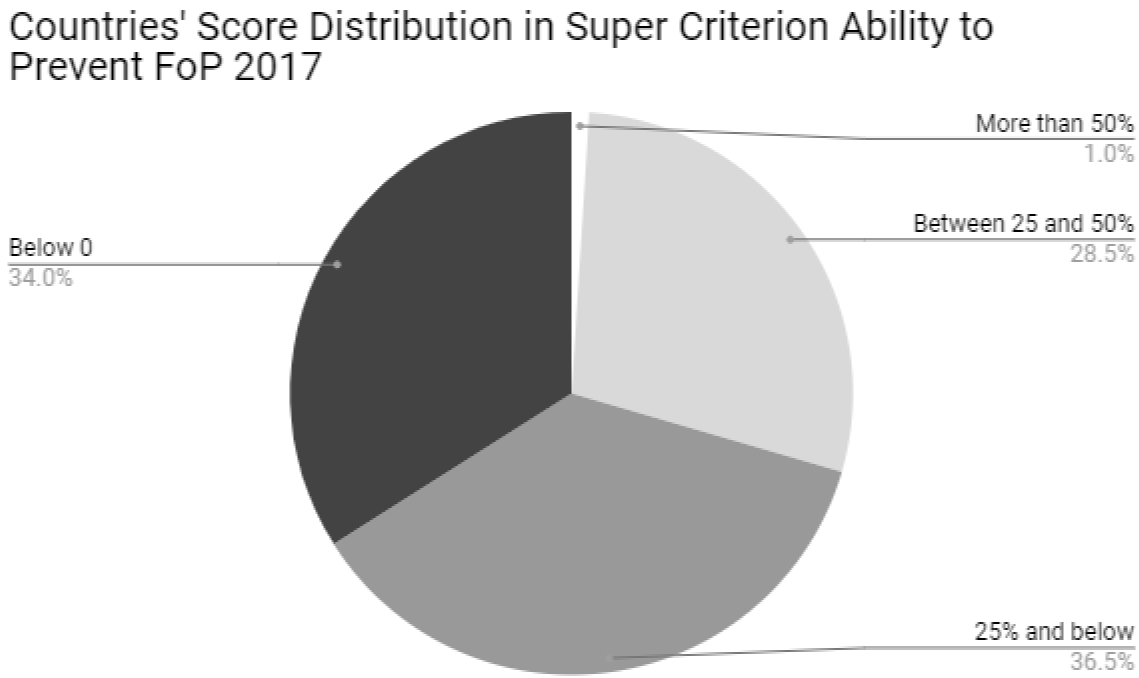

Figure 1. The pie chart shows the score distribution of countries in their *Ability to Prevent Proliferation Financing* in the PPI for 2017. The majority of countries score less than 25 percent of the available points. This figure includes corrected values for Viet Nam and Venezuela.

The PPI lists countries by score in the super criterion *Ability to Prevent Proliferation Financing*, which leads to a ranking. Although we do not release this ranking publicly, we provide below those countries that are in the top third and bottom ten percent by ranking.

Top third by rank (in alphabetical order):
Albania, Andorra, Antigua and Barbuda, Armenia, Australia, Austria, Bahamas, Bahrain, Barbados, Belgium, Bhutan, Botswana, Bulgaria, Burkina Faso, Cameroon, Canada, Chile, Cook Islands, Cyprus, Czech Republic, Denmark, Estonia, Fiji, Finland, France, Germany, Greece, Grenada, Hungary, Iceland, Ireland, Israel, Italy, Japan, Latvia, Lesotho, Liechtenstein, Lithuania, Macedonia, Malawi, Malta, Mauritius, Monaco, Nauru, Netherlands, New Zealand, Niue, Norway, Palau, Poland, Portugal, Romania, Samoa, San Marino, Singapore, Slovakia,

Slovenia, Solomon Islands, Spain, Sweden, Timor-Leste, Togo, Tonga, United Kingdom of Great Britain and Northern Ireland, United States of America, Uruguay, and Zambia.

Bottom 10% by rank (in alphabetical order):
Afghanistan, Belarus, Burundi, Democratic People's Republic of Korea (DPRK), Egypt, Eritrea, Iran (Islamic Republic of), Iraq, Lebanon, Libya, Morocco, Myanmar, Paraguay, Russian Federation, Serbia, Somalia, South Sudan, Sudan, Syrian Arab Republic, Thailand, and Ukraine.

Updates Since the Publication of the PPI 2017 regarding proliferation financing

Since the publication of the index, Institute staff have continuously updated and revised the data for a 2018 version of the ranking. Throughout the process, trends observed in the 2017 data on proliferation financing remain. Countries still perform poorly overall, and only three countries received 50 percent or more of the possible points.

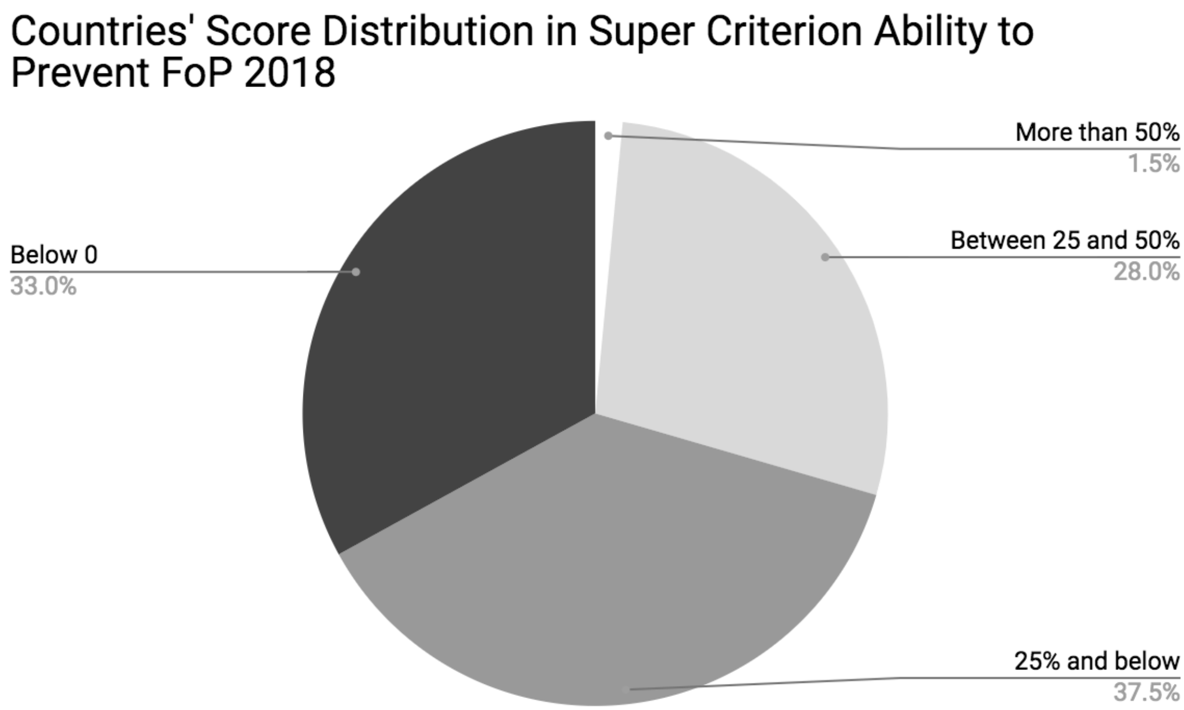

Figure 2. The pie chart shows the score distribution of countries in their *Ability to Prevent Proliferation Financing*, 2018 ranking. The majority of countries score less than 25 percent of the available points. In general, the distribution in these four broad categories has only minimally changed from 2017 and the need for further action is clearly visible.

As stated before, the PPI lists countries by score, generating a ranking. Although we do not release this ranking, we again provide those countries that are in the top third by ranking and the bottom ten percent in the 2018 ranking.

The top third of countries in the 2018 version are 80 percent the same as the 2017 version. 13 countries in the top third were replaced by other countries. For 2018, the top third countries are (alphabetically): Andorra, Angola, Antigua and Barbuda, Armenia, Australia, Austria, Bahrain, Bangladesh, Bhutan, Brazil, Bulgaria, Cameroon, Canada, Chile, Cook Islands, Croatia, Czech Republic, Estonia, Fiji, Finland, France, Germany, Grenada, Hungary, Iceland, Ireland, Israel, Italy, Japan, Latvia, Lesotho, Liechtenstein, Lithuania, Macedonia, Malawi, Malta, Mauritius, Mexico, Monaco, Mongolia, Nauru, Netherlands, New Zealand, Niue, Oman, Palau, Panama, Papua New Guinea, Poland, Portugal, Republic of Korea, Romania, San Marino, Saudi Arabia, Singapore, Slovakia, Slovenia, Solomon Islands, Spain, Sweden, Tonga, Trinidad and Tobago, United Kingdom of Great Britain and Northern Ireland, United States of America, Uruguay, Venezuela (Bolivarian Republic of), and Zambia.

The bottom 10 percent remained the same, except for three countries. For 2018, they are, alphabetically: Afghanistan, Belarus, Burundi, Central African Republic, DPRK, Egypt, Eritrea, Iran (Islamic Republic of), Iraq, Lao People's Democratic Republic, Lebanon, Libya, Morocco, Myanmar, Paraguay, Russian Federation, Serbia, Somalia, South Sudan, Sudan, and Tajikistan.

Comparison of Proliferation Financing Scores of PPI 2017 and PPI 2018

The point distribution graphs of countries' scores show that scores are generally increasing. Figures 3 and 4 show the point distribution graphs for 2017 and 2018, respectively. On average, all countries received two more points in the 2018 round of data collection than in the 2017 version.[4] Countries that received updates in FATF data, whether it be a new Mutual Evaluation Report or a new follow-up report, gained an average of six points based on that data alone. Since the end of the data collection period for 2017, the following countries received a new Mutual Evaluation Report: Andorra, Barbados, Botswana, Cambodia, Cuba, Denmark, Ethiopia, Ireland, Mexico, Mongolia, Nicaragua, Panama, Portugal, Slovenia, Thailand, and Ukraine. The following countries received a new follow-up report: Austria, Fiji, Hungary, Samoa, Suriname, Tunisia, and Vanuatu. Institute staff noted, however, that a new Mutual Evaluation Report did not always result in improvements and increased points. In some instances, countries' compliances were re-evaluated and given a "lower grade" than in a previous report.

The overall scores still cluster well below half the possible points (see figure 4). Ideally in the future, the cluster would move as a group toward higher points.

[4] The averages of points received are eight and ten in 2017 and 2018, respectively.

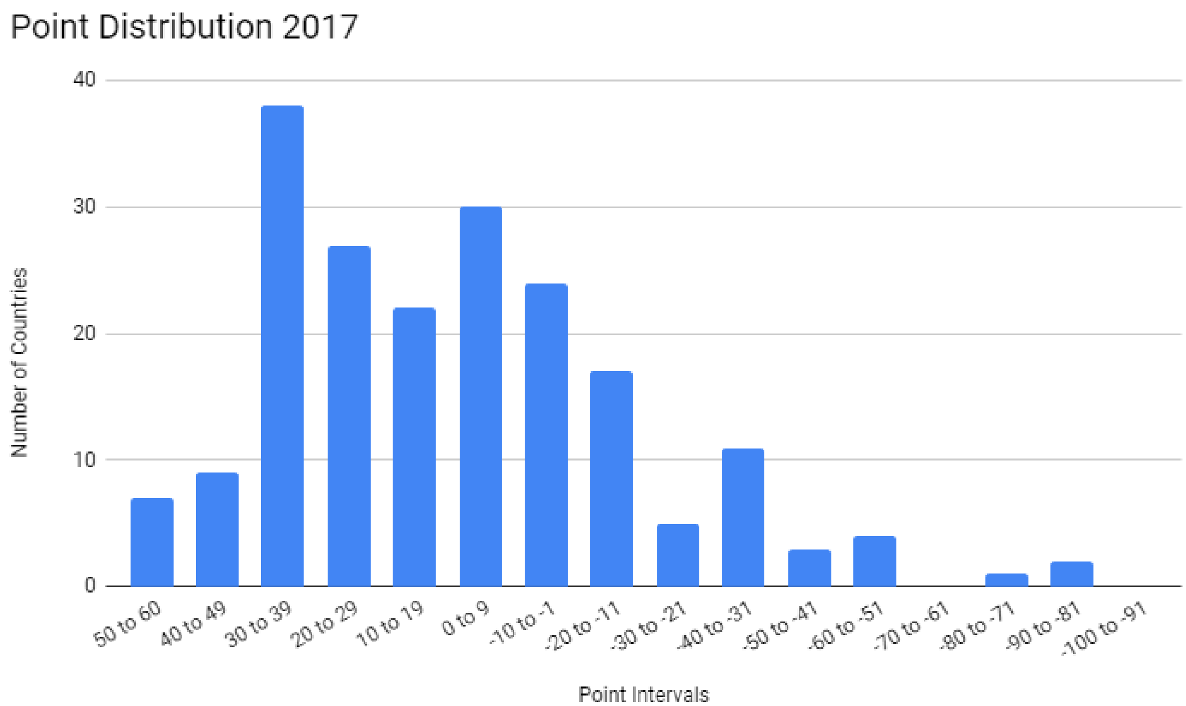

Figure 3. Point distribution based on data collected in 2017 out of a total of 110 points, excluding extra credit.

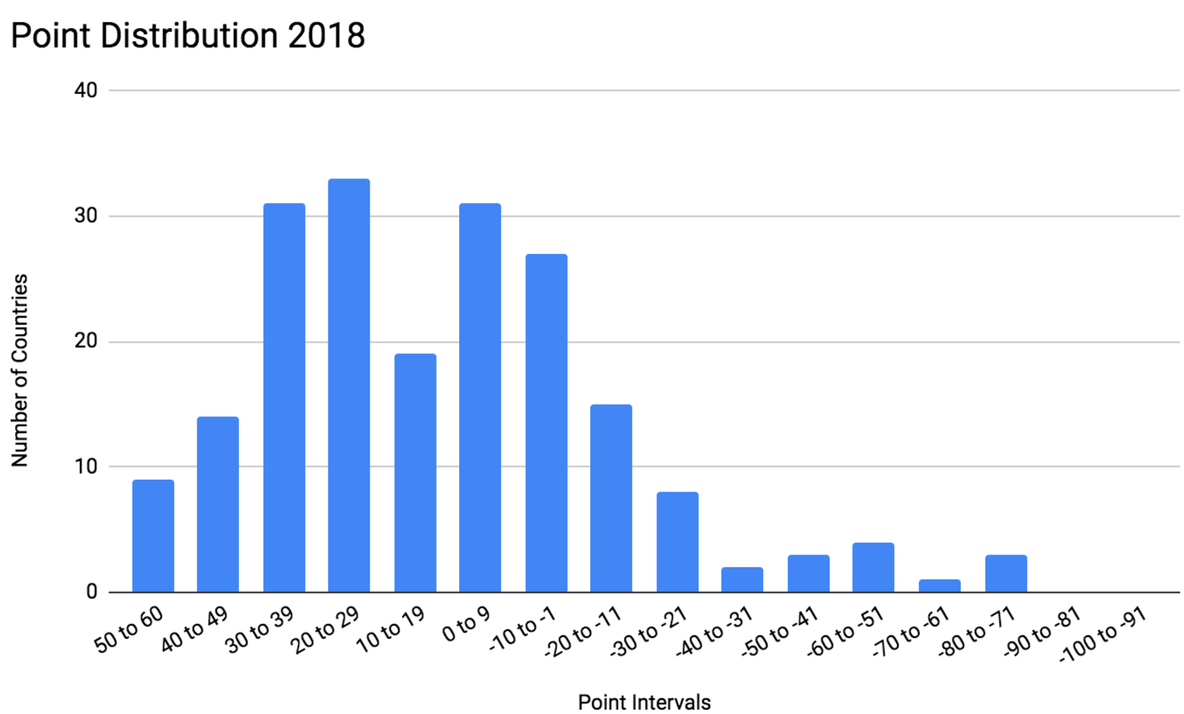

Figure 4. Point distribution based on revised data collected in 2018 out of a total of 110 points, excluding extra credit.

Summary of Key Findings and Recommendations:

In the Institute's PPI for 2017 ranking, the proliferation financing super criterion is the one in which countries collectively performed the worst. An overriding conclusion is that most countries do not perform well on preventing proliferation financing.

The Institute has developed a range of recommendations while producing the PPI and working with proliferation financing experts to develop its methodology. One of the most critical recommendations is that countering proliferation financing needs to be integrated into many more aspects of counterproliferation including export controls. Some specific recommendations follow.

1. All countries should work closely with FATF and its regional bodies to improve their efforts to prevent proliferation financing.
    1.1. They should also work to improve compliance with proliferation financing-relevant FATF recommendations.
    1.2. All countries should join or aspire to join FATF, if they have not already done so, and work closely with the organization to improve the integrity of their national financial controls against proliferation financing and other financial crimes. Israel is an example of a country that has prioritized joining FATF and is involved in a process of reviews. Membership and cooperation with FATF would not only reduce the chances that states' financial institutions will be used for the financing of proliferation, but also will reduce illicit outflows, the rise and permeability of black markets, and other nefarious business that could be taking place. Joining FATF is a way for countries to attract foreign investment and trade.
    1.3. Following coordination and assistance in bringing their controls into line with FATF-recognized best practices, countries should apply to have a mutual evaluation report conducted on them.

2. Each country should conduct a risk assessment of proliferation financing, and its agencies should address any gaps identified.
    2.1. Even though money laundering and terrorism financing may have similar indicators to proliferation financing, they should be differentiated from proliferation financing so that FoP risk assessments are comprehensive and accurate. Assessments should include expansive models of FoP rather than be based mainly on previous export and sanctions case studies.
    2.2. Each government should have adequate legislation in place; an effective system of coordination among departments working on FoP; well resourced, investigative Financial Intelligence Units; adequate enforcement; outreach to financial institutions; a system of mandatory sharing of information domestically (including sensitive information); ability to share information internationally; and

effective coordination with other governments.

3. A country's financial institutions need to be able to monitor, detect, report, and act upon suspicious financial transactions.
    3.1. Financial institutions need to have access to a secure and reliable mechanism to report suspicious financial transactions to the government. This includes the government creating adequate legislation mandating reporting, conducting outreach, and setting up points of contacts, as well as reporting mechanisms and ideally reporting requirements.
    3.2. Countries should help financial institutions identify and freeze suspicious transactions. Because of the difficulties of accomplishing this goal, the U.S. government should launch an interagency study to improve communication and information sharing with financial institutions, including insurance companies, and to develop better solutions for automated counter-proliferation financing screening tools.

4. Countries should participate in bilateral, multilateral, and law enforcement mechanisms to share FoP information and collaborate to enhance the effectiveness of counter proliferation financing efforts and facilitate adherence to international standards.
    4.1. Although there are many ways to implement this recommendation, one promising group for promoting cooperation among Financial Intelligence Units (FIUs) on FoP is the Egmont Group, which is a united body of 155 countries' Financial Intelligence Units.[5] The Egmont Group members' collaboration on money laundering and terrorism financing greatly improves the efficacies of the Financial Intelligence Units. The Egmont Group should expand its focus to specifically include proliferation financing. This could be accomplished through the inclusion of FoP criteria in the membership application and also through the development of an "Information Exchange on FoP Working Group."[6]

5. The Committee on United Nations Security Council Resolution 1540 (2004) should continue to promote the implementation of the financial control aspects of the resolution.
    5.1. The financing aspects of the 2017 matrix template mostly focus on terrorism financing. While item 11 in II. OP 2 - Nuclear Weapons (NW), Chemical Weapons (CW) and Biological Weapons (BW) refers to "Finance[ing] above mentioned activities,"[7] the matrices should be updated to more specifically

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[5] "About - The Egmont Group," The Egmont Group, https://egmontgroup.org/en/content/about (Accessed July 9, 2018).

[6] The suggested name would be in line with the already existing "Information Exchange on ML/TF Working Group." See: "Information Exchange on ML/TF Working Group (IEWG)," The Egmont Group, https://egmontgroup.org/content/information-exchange-mltf-working-group-iewg (Accessed July 6, 2018).

[7] "Approved 1540 Committee Matrix (2017)," 1540 Committee, http://www.un.org/en/sc/1540/national-implementation/1540-matrices/matrix-template.shtml (Accessed July 9, 2018).

reference proliferation financing.

6. Efforts to prevent proliferation financing should be incorporated into export control regimes on a national basis and vice versa.
    6.1. National export control legislation should systematically include mechanisms and regulations to incorporate countering financial proliferation into governmental entities, including Financial Intelligence Units, in the processes of export control, including licensing decisions, enforcement, and customs clearance.
    6.2. Multilateral export control regimes should include FoP information in their deliberations and promote these efforts by adjusting their membership guidelines and sharing best practices to prevent proliferation financing.

7. FATF is in a unique position to drive many of the above-mentioned recommended actions and changes and should do so. Financing of proliferation should be treated broadly and as a separate subject to money laundering and terrorist financing.
    7.1. The FATF should add recommendations that more specifically focus on improving countries' capabilities to prevent and detect financing of proliferation. For example, it could integrate its 2008 "Indicators of Possible Proliferation Financing"[8] into recommendations, allowing them to evaluate countries' actions on preventing proliferation financing.
    7.2. At the plenary meetings, the FATF working group should discuss adjusting the language in several of the existing 40 FATF recommendations to extend them beyond CFT and AML, to include FoP. For example, FATF could encourage countries to conduct risk assessments for FoP by adding it to the language in Recommendation 1.[9]
    7.3. FATF should expand the number of categories it uses to evaluate countries with regard to proliferation financing and financial crime. For example, countries that actively improve their financial controls often remain in the partially compliant category, which may not encourage further improvements.
    7.4. FATF should standardize the evaluation process for all its regional bodies. It should seek to diminish disparities in levels of stringency utilized in the evaluations in order to bring about improved understanding of where countries stand in the FATF mutual evaluations and compliance categories.

8. Developed countries should encourage and provide resources to the FATF to increase the speed at which they conduct follow-up Mutual Evaluation Reports. This would reduce

[8] "Indicators of possible proliferation financing," as mentioned in Annex 1 to the 2008 FATF *Typologies Report on Proliferation Financing.* See: FATF, "Proliferation Financing Report," June 18, 2008, p. 54, http://www.fatf-gafi.org/media/fatf/documents/reports/Typologies%20Report%20on%20Proliferation%20Financing.pdf

[9] FATF Recommendation 1 is called "Assessing risks & applying a risk-based approach." For the full text of recommendations see: FATF, *International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation–The FATF Recommendations,* Paris, France, published February 2012, https://www.un.org/sc/ctc/wp-content/uploads/2016/10/fatf_recommendations_reprint2012.pdf

current lag times between countries self-reporting on their performance following a Mutual Evaluation Report, and FATF's verification process.

9. Fulfilling many of the PPI's sub-criteria under the *Ability to Prevent Proliferation Financing* super criterion, particularly improving a country's performance under many of the negative indicators, would strengthen financial controls overall.

10. Countries with advanced knowledge and experience in the area of countering proliferation financing should establish outreach programs that provide training and share best practices with countries seeking to improve financial controls.[10]
    10.1. In this effort, certain groups of countries should be prioritized and put under extra scrutiny and pressure. Such groups include responsible countries that nonetheless score particularly low in the PPI, those planning to acquire nuclear power reactors, and countries known to have violated financial sanctions on North Korea.[11]
    10.2. All UN member states should be encouraged to make use of a platform provided by the 1540 Committee, which helps to match countries seeking assistance with countries able to provide assistance.

Iran and FATF

Iran performs particularly poorly on the PPI and also does exceptionally poorly under the super criterion *Ability to Prevent Proliferation Financing*. It ranked 199 out of 200 in the ranking of this super criterion in 2017, and last overall for 2018.

Every year from at least 2008, Iran has been listed in the FATF annual public statements as a country with concerning anti-money laundering (AML) and counter-financing of terrorism (CFT) deficiencies. On February 25, 2009, FATF decided to publicly "call on its members and urge all jurisdictions to apply effective counter-measures to protect their financial sectors from money laundering and financing of terrorism risks emanating from Iran."[12] The only other country for which FATF had called such drastic measures was North Korea. Iran remained on the list of "high-risk and non-cooperative jurisdictions" for the subsequent seven years, until in June 2016, FATF suspended its countermeasures based on an Action Plan submitted by Iran. However, in February 2018, FATF stated that "Iran's action plan has now expired with a majority of the action items remaining incomplete."[13] It also stated, "Given that Iran has draft

[10] The PPI team was unable to locate many such programs outside of FATF.
[11] "How to Obtain the Book," Institute for Science and International Security, http://isis-online.org/ppi/detail/obtain-the-book/
[12] FATF, "FATF Public Statement - 16 February 2012," Paris, February 16, 2012, http://www.fatf-gafi.org/publications/high-riskandnon-cooperativejurisdictions/documents/fatfpublicstatement-16february2012.html
[13] FATF, "Monitoring Iran's actions to address deficiencies in its AML/CFT system," Outcomes of the FATF Plenary, February 21-23, 2018, Paris, February 23, 2018, http://www.fatf-gafi.org/countries/a-c/argentina/documents/outcomes-plenary-february-2018.html

legislation currently before Parliament, the FATF decided at its meeting this week to continue the suspension of counter-measures. Depending upon Iran's progress in completing its action plan, the FATF will take further steps in June 2018."

Civil society is not able to attend the FATF plenary meetings, but a Reuters report suggests that Iran was given extended time to fulfill its Action Plan requirements and that FATF will again address the issue in October.[14] Nevertheless, we assess that it is unlikely that Iran intends to fully implement its Action Plan and comply with FATF and the standards it sets in the future. In May 2018, the governor of the Central Bank of Iran was sanctioned by the U.S. Treasury's Office of Foreign Assets Control for assisting the Islamic Revolutionary Guard Corps' Quds Force with channeling money to Hezbollah. This shows how deeply involved Iran's financial system is in illicit activities.[15] On June 10, 2018, the Iranian parliament voted to suspend efforts to join the U.N. Convention for the Suppression of Financing of Terrorism, one of FATF's major requirements of Iran. On June 20, 2018, Iran's Supreme Leader Ayatollah Ali Khamenei, who is the ultimate decision maker on the country's policies, announced that he has no interest in joining the convention.[16] Therefore, we recommend the re-imposition of counter-measures against Iran.

[14] "Anti-money laundering body gives Iran until October to complete reforms," Reuters. June 29, 2018, https://www.reuters.com/article/us-iran-sanctions-fatf/anti-money-laundering-body-gives-iran-until-october-to-complete-reforms-idUSKBN1JP34N

[15] Toby Dershowitz, "Risks of Doing Business with Iran," *FDD Background Resource Guide* (Foundation for Defense of Democracies, Washington, D.C., June 21, 2018), http://www.defenddemocracy.org/media-hit/toby-dershowitz-risks-of-doing-business-with-iran1/

[16] Toby Dershowitz and Saeed Ghasseminejad, "Iran's supreme leader just torpedoed his country's best chance to get off the terror financing blacklist," *Business Insider*, June 22, 2018, http://www.businessinsider.com/iran-sank-its-best-chance-to-get-off-terror-financing-blacklist-2018-6

Appendix: Methodology used for the Super Criterion *Ability to Prevent Proliferation Financing* in the Peddling Peril Index for 2017

To develop a numerical ranking of performance on the super criterion *Ability to Prevent Proliferation Financing*, countries received points based on sub-criteria derived mostly from the FATF determinations. These sub-criteria assess countries' theoretical capabilities to prevent money laundering and proliferation financing based on their financial regulatory systems and counter-illicit financing programs. These eleven sub-criteria are characterized as "positive indicators."

The PPI then takes away points according to five "negative indicator" sub-criteria, or tangible information and examples of poor controls, such as when countries are known to have been involved in illicit finance, are sanctioned by major world economies for illicit financing activities, have assisted others in proliferation financing, or consistently do not act to prevent illicit financing efforts.

The positive and negative indicators are assigned a low, medium, or high impact for scoring purposes.

The project next assigns or takes away available "extra credit" points according to two other FATF-related sub-criteria. Finally, the judgment of experts in proliferation financing is used to take away or assign points based on their knowledge of proliferation financing in certain countries. After extra credit and expert knowledge points, a country could receive a total of 110 points for its *Ability to Prevent Proliferation Financing.*

Overall, there is little international effort devoted to assessing proliferation financing, which is why the PPI relies heavily on FATF evaluations. However, much of the FATF's information applies to broader illicit financing activities rather than specifically to proliferation financing. FATF only added proliferation financing as a focus in 2012. Since then, FATF evaluations include looking at countries' theoretical ability to implement international financial sanctions and the effectiveness of the controls against those countries under international financial sanctions, including investigation and enforcement actions. This evaluation data was only available for a limited number of countries. Thus, the PPI team decided to factor in the other point addition and subtraction categories.

Positive indicators:

- Compliance with selected FATF recommendations (for how recommendation 7 and Immediate Outcome 11 are evaluated, see below under Extra Credit)

  FATF is the organization that provides the most data regarding a country's banking regulations and practices. The objectives of FATF are to set standards and promote effective implementation of legal, regulatory, and operational measures for combating money laundering, terrorist financing, and other related threats to the integrity of the international financial system. It publishes a periodically updated set of recommendations that all member countries should follow to prevent financial crimes and publishes evaluations of individual counties' compliance with each recommendation. The evaluations are conducted by FATF or its regional FATF bodies and are titled *Mutual Evaluation Reports*. For each recommendation, potential deficiencies are listed, and a final conclusion is drawn, which can be that the country is Not Compliant, Partially Compliant, Largely Compliant, or Compliant with the specific recommendation. With the emergence of additional threats to the international financial system, including terrorist financing, and subsequently proliferation financing, FATF recognized the need to update its recommendations in 2003, and again in 2012. The Mutual Evaluation Reports based on the 2003 guidelines versus the 2012 guidelines often number their recommendations differently, and as a result the PPI lists a recommendation and its associated year, such as FATF Recommendation 2 (2012), meaning it is the one from the 2012 guidelines. As of April 2017, only 31 countries have undergone an evaluation based on the 2012 standards. (As of June 2018, 43 countries have undergone a FATF evaluation based on 2012 standards). To establish common ground between countries that have undergone a FATF evaluation before and after 2012, the PPI team only took into consideration recommendations found in both the new and old guidelines. The following FATF recommendations (FATF R.'s) have been carefully evaluated and selected by consulting financing of proliferation experts as most relevant to preventing proliferation financing, based on their experience with what governments need the most to prevent this illicit activity[17]:

- FATF Recommendation 2 (2012) 31 (2003) National Coordination[18]: "Countries should have national [anti-money laundering/counter-terrorist financing] policies [...]. Countries should ensure that [...] relevant competent authorities, at the policymaking and operational levels, have effective mechanisms in place which enable them to cooperate, and, where appropriate, coordinate domestically with each other concerning the development and implementation of policies and activities to combat money laundering, terrorist financing and the financing of proliferation of weapons of mass destruction." This is a high impact indicator.

[17] For the full text of recommendations see: FATF, *International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation - The FATF Recommendations*, Paris, France, published February 2012, updated October 2016, http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf

[18] This formulation reflects the fact that Recommendation 2 in 2012 standards is the equivalent of Recommendation 31 in 2003 standards.

- FATF Recommendation 40 (2012 and 2003) International Cooperation / Other Forms of Cooperation: "Countries should ensure that their competent authorities can rapidly, constructively, and effectively provide the widest range of international cooperation in relation to money laundering, associated predicate offences and terrorist financing." This is a high impact sub-criterion.

- FATF Recommendation 10 (2012) 5 (2003) Customer Due Diligence (CDD): "Financial institutions should be prohibited from keeping anonymous accounts or accounts in obviously fictitious names. [...] The principle that financial institutions should conduct CDD should be set out in law. [...] Financial institutions should be required to verify the identity of the customer and beneficial owner before or during the course of establishing a business relationship or conducting transactions for occasional customers." This is a medium impact indicator.

- FATF Recommendation 13 (2012) 7 (2003) Correspondent Banking: Financial institutions should collect additional information before conducting cross-border correspondent banking, and they "should be prohibited from entering into, or continuing, a correspondent banking relationship with shell banks." It is a medium impact sub-criterion.

- FATF Recommendation 26 (2012) 23 (2003) Regulation and Supervision: Financial institutions should be licensed, registered, regulated, and subject to monitoring. "[...] Countries should not approve the establishment, or continued operation, of shell banks." This is a medium impact sub-criterion.

- FATF Recommendation 30 (2012) 27 (2003) Law Enforcement Responsibilities: "Countries should ensure that designated law enforcement authorities have responsibility for money laundering and terrorist financing investigations [...]." This is a low impact indicator.

  The PPI assigned points (with a maximum score of 65 points) based on country compliance with this selected set of FATF recommendations that encapsulate critical elements or essential features of a system that prevents proliferation financing.

- Unavailability of Trade Financing

As part of its 2014 *Global Enabling Trade Index,* The World Economic Forum measures how easily a business can finance trade at an affordable cost, based on conducted Executive Opinion Surveys. According to the World Economic Forum definition, the cost of financing trade includes trade credit insurance and trade credit, such as letters of credit, bank acceptances, advanced payments, and open account arrangements. Countries are ranked out of 138, with 1 being the easiest country in which to obtain trade financing and 138 being the most difficult. For the PPI, this is used as a low impact indicator to assess how attractive a country is as an illicit finance hub. In other words, the unavailability of trade finance can be a small deterrent to proliferation financing.

The reasons for this include: 1) 80 percent of trade financing takes place through "open accounts," i.e. wire transfers. So, the unavailability of trade finance can render only 20 percent of all transactions in a country susceptible to illicit financing activities[19] ; 2) Trade financing applies mainly to countries at the origin and end point of transactions and not to countries in-between, limiting the opportunities for exploitation; and 3) State-sponsored proliferation networks are likely willing to dedicate more financial resources than profit-seeking businesses, which could make unavailability of trade financing a deterrent because of the additional time, documentation, and paper trail required. Developing countries often have an unavailability of trade financing, but surprisingly some small, developed countries such as Lithuania or Portugal, have an unavailability of trade financing as well. Greater availability of trade financing is seen in common trading hubs such as Hong Kong and Malaysia, but also in smaller, inconspicuous countries such as Malta, Oman, and Bahrain. It is a medium impact indicator.

- Low cumulative illicit financial outflows[20]

  This indicator measures illicit financial outflows from developing countries in 2013. Data is collected and published by Global Financial Integrity. According to the organization:

  Illicit outflow, measured in millions of U.S. dollars, is money illegally earned, transferred, and/or utilized. Some examples of illicit financial outflows listed might include:

  - *A drug cartel using trade-based money laundering techniques to mix legal money from the sale of used cars with illegal money from drug sales;*
  - *An importer using trade misinvoicing to evade customs duties, value added taxes (VAT), or income taxes;*
  - *A corrupt public official using an anonymous shell company to transfer dirty money to a bank account in the United States;*

[19] Jonathan Brewer, *Study of Typologies of Financing of WMD Proliferation, Interim Report* (London, United Kingdom: Project Alpha, King's College London, February 5, 2017), http://projectalpha.eu/wp-content/uploads/sites/21/2017/02/Study-of-Typologies-of-Financing-of-Proliferation-Interim-Report-5-Feb-2017.pdf

[20] Global Financial Integrity, *Illicit Financial Outflows from Developing Countries, 2004-2013*, See Appendix Table 5, Illicit Hot Money Narrow Outflows (HMN), May 1, 2017, http://www.gfintegrity.org/report/illicit-financial-flows-to-and-from-developing-countries-2005-2014/

    - *A human trafficker carrying a briefcase of cash across the border and depositing it in a foreign bank; or*
    - *A terrorist wiring money from the Middle East to an operative in Europe.*

  As none of these are directly related to proliferation financing, the measure is deemed a medium impact indicator. Data are only collected for developing countries, which is useful as it balances out points that countries may have undeservedly received for having unavailable trade financing. Although illicit outflow is measured in absolute values, the PPI team took into account the size of illicit financial outflows in relation to a country's gross domestic product (GDP). Countries are awarded more points for not having large cumulative illicit outflows.

- Country has FATF or FATF Regional Body Membership[21]

  FATF has established eight regional bodies to achieve global dissemination and coordination in order to promote better understanding and implementation of its international standards as highlighted in the FATF 40 (49 for post-2003) recommendations. Most countries are either FATF members or members of a FATF-style regional body; some are members of both. The level of organization and dynamic varies within the different groups. Before being able to become a FATF member, countries undergo a rigorous review process. FATF membership is awarded more points than regional body membership. The regional bodies are:

    - The Eurasian Group (EAG)
    - Asia/Pacific Group (APG)
    - Caribbean Financial Action Task Force (CFATF)
    - Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism of the Council of Europe (MONEYVAL)
    - Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG)
    - Financial Action Task Force on Latin America (GAFILAT)
    - Intergovernmental Action Group Against Money Laundering in West Africa (GIABA).
    - Middle East and North Africa Financial Action Task Force (MENAFATF)
    - The Task Force on Money Laundering in Central Africa (GABAC)

  This is a medium impact indicator.

[21] FATF, *Countries*, 2017, http://www.fatf-gafi.org/countries/

● FATF compliance score[22]

The FATF compliance score is available for 90 countries on the 2015 *Financial Secrecy Index (FSI),* published by the Tax Justice Network. In the FSI, FATF compliance is indicator 11, "Anti-Money Laundering." According to the FSI report, compliance with all available recommendations (49 recommendations post-2003, or 40 recommendations post-2012) was calculated as a percentage, where "a 100% rating indicates that all recommendations have been rated as 'compliant', whereas a 0% rating indicates that the jurisdiction is wholly 'non-compliant.'"[23] Working with FATF to comply with general recommendations by implementing regulations and best practices is the first step for a country to prove its full commitment to financial transparency and anti-money laundering efforts. Despite some degree of duplication with the FATF recommendations above, this is a good indicator of general ability to prevent financial crimes. This is a medium impact indicator.

● Lack of denied parties by United States and European Union[24]

Countries without entities sanctioned by the United States' OFAC, BIS, or the European Union's sanctions lists are viewed in general as having done better at detecting illicit activity and stopping it. Thus, for the PPI, these countries are viewed as capable of monitoring and detecting illicit activities and gain points. This sub-criterion allows for a rough measure of what a country knows about its internal business. Since it is only a rough measure, it is assigned low impact.

Variability in FATF compliance evaluations

In ranking the 31 countries that underwent the 2012 FATF evaluation, the PPI team noted that the way compliance judgments are made is not standardized throughout the regional FATF bodies. While some FATF bodies appear very strict and require that all deficiencies are removed before awarding a country the two highest levels of compliance (Largely Compliant and Compliant), other evaluating bodies seem to be more generous in assigning compliance levels. For example, the PPI team found that the European regional FATF body tends to be harsher in its

[22] Tax Justice Network, "Financial Secrecy Index - Country Reports," 2015, http://www.financialsecrecyindex.com/jurisdictions

[23] Tax Justice Network, "Key Financial Secrecy Indicators," July 22, 2015, http://www.financialsecrecyindex.com/PDF/11-Anti-Money-Laundering.pdf

[24] United States Department of the Treasury, Office of Foreign Assets Control, "SDN List by Country," https://www.treasury.gov/ofac/downloads/ctrylst.txt ; United States Department of Commerce, Bureau of Industry and Security, "Supplement No. 4 to Part 744 - ENTITY LIST," *Export Administration Regulations*, https://www.bis.doc.gov/index.php/forms-documents/regulations-docs/federal-register-notices/federal-register-2014/957-744-supp-4-1/file (Accessed Winter 2016); European Commission, "European Union - Restrictive measures (sanctions) in force," Updated April 26, 2017, https://eeas.europa.eu/sites/eeas/files/restrictive_measures-2017-04-26-clean.pdf. A change from last year is that the United States is not treated differently in regard to European Union sanctions.

assessments. The CFATF, or Caribbean regional body, and GAFILAT, or Latin American regional body, seem more generous in their assessments, which skews the outcome for a ranking.

Explanation for the need for additional negative indicators:

The final ranking would be less reliable if only the positive FATF-derived sub-criteria above were used to derive a ranking in this super criterion. Although FATF is the only organization that systematically tracks countries' actions to improve legal financial controls aimed at reducing threats to the integrity of the international financial system, its reporting contains many gaps. As discussed above, not all countries have been evaluated based on the 2012 standards, in particular FATF Recommendation 7 and Outcome 11, which directly relate to preventing proliferation finance. These gaps complicate gaining insights into what many countries do to prevent financial crime. The extent to which these gaps impacted the PPI ranking is difficult to evaluate.

Another issue concerns the FATF's evaluation methodology. Although the FATF evaluations are strong, there appear to be some potential weaknesses or biases that argue for the use of more sub-criteria. For example, compliance judgments published in follow-up FATF reports are derived based on a less rigorous evaluation process than the full reports. In follow-up reports, self-reporting plays a much greater role.[25] In addition, there are differences in how regional FATF organizations evaluate countries, as discussed above. This issue could risk that countries in certain FATF regions are ranked higher than what would be expected, based on other indicators such as money laundering. Lastly, FATF evaluations do not include the impact of enforcing UN financial sanctions on Iran and the DPRK. Those sanctions include a number of financial measures such as activity-based sanctions, vigilance requirements, and many others. Although these are described in non-binding FATF Guidance dated June 2013, they are not formally evaluated during the mutual evaluation processes. This issue could imply that countries may be doing better than the Mutual Evaluation Reports conclude.

A method was developed to more effectively rank countries under this super criterion because the number of positive sub-criteria based on FATF information has already relatively low and FATF information was not complete. This additional set of sub-criteria focus on negative outcomes, such as the existence of substantial black markets in countries or countries having a high number of sanctioned entities. A negative sub-criterion means that points are subtracted instead of added.

Negative indicators:

[25] See Organisation for Economic Co-operation and Development, Annex 2. A1, "A Note on FATF Data," in *Illicit Financial Flows from Developing Countries: Measuring OECD Response*s, 2014, https://www.oecd.org/corruption/Illicit_Financial_Flows_from_Developing_Countries.pdf

- Presence of denied parties by United States and European Union[26]

  Countries with entities sanctioned by the United States' OFAC, BIS, or the European Union's sanctions lists likely failed to detect illicit activity until after it occurred. Thus, for the PPI, these countries are treated as less capable of monitoring and detecting illicit activities. When assigning points for this sub-criterion, the number of entities was not taken into consideration, but more points were taken away for a country having entities on multiple sanctions lists. It is measured as a negative indicator with high impact, since it indicates actual instances where illicit activity has been detected.

- Appearance on the 2017 State Department List of Countries posing Money Laundering and Financial Crime concerns[27]

  The State Department Bureau for International Narcotics and Law Enforcement Affairs identifies in its March 2017 report "Countries/Jurisdictions of Primary Concern" for "Money Laundering and Financial Crimes." Using country profiles, the report points out weaknesses in those countries' enforcement or justice systems which pose challenges to the implementation of financing regulations. Examples of observed implementation challenges include "limited resources, lack of technical expertise, and poor infrastructure" as well as "administrative hurdles" and "corruption." This sub-criterion is medium impact.

- Worldwide Biggest Black Markets ranking[28]

  This indicator is a ranking of the world's 93 biggest black markets published by Havoscope, measured by their size in U.S. dollars. Although the size was measured in absolute values, the PPI team took into account the size of the black market in relation to a country's GDP. Black markets are linked to financial proliferation because they facilitate the financing of the illicit procurement of goods, which require secretive means. It is a medium impact sub-criterion.

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[26] United States Department of the Treasury, Office of Foreign Assets Control, "SDN List by Country," https://www.treasury.gov/ofac/downloads/ctrylst.txt ; United States Department of Commerce, Bureau of Industry and Security, "Supplement No. 4 to Part 744 - ENTITY LIST," *Export Administration Regulations*, https://www.bis.doc.gov/index.php/forms-documents/regulations-docs/federal-register-notices/federal-register-2014/957-744-supp-4-1/file (Accessed Winter 2016); European Commission, "European Union - Restrictive measures (sanctions) in force," Updated April 26, 2017, https://eeas.europa.eu/sites/eeas/files/restrictive_measures-2017-04-26-clean.pdf

[27] United States Department of State, "International Narcotics Control Strategy Report - Money Laundering and Financial Crimes," Bureau for International Narcotics and Law Enforcement Affairs, Volume 2, March 2017, https://www.state.gov/documents/organization/268024.pdf

[28] Havocscope Global Black Market Information, "Havocscope Country Risk Ranking," http://www.havocscope.com/country-profile/ (Accessed July 2017).

- Significant illicit financial outflows[29]

  This indicator again uses data collected and published by Global Financial Integrity, measuring illicit financial outflows from developing countries in 2013. The PPI team decided that significant illicit financial outflows should be penalized. Points are taken off for countries that had more than $100 million in illicit financial outflows in 2013. It is a medium impact indicator.

- Lack of influence of corruption[30]

  Corruption can interfere significantly in the implementation of financial controls. Companies engaged in exporting may believe they can simply ignore any legal export or financial requirements if they believe there is little likelihood of being investigated or prosecuted. Corruption would likely inhibit strong financial controls and enforcement. In this sub-criterion, the 2016 Corruption Perceptions Index (CPI) by Transparency International is used as a measure of corruption in 176 countries. This index was selected from a variety of corruption measures and indices, mainly because this index lists the most countries and is widely respected. The PPI team used the rank of a country in the CPI to assign points, rather than its score derived by Transparency International. The points in this sub-criterion were assigned in an inversely proportional way to their relative rank. If the country or entity did not appear on the CPI, it was not assigned points. This sub-criterion has a medium impact.

"Extra-Credit" Opportunity:

For the 31 countries that were evaluated according to post-2012 FATF standards, the PPI offered an "extra credit opportunity," which allowed for the addition (or in a few cases the subtraction) of points. Information on those countries is included in the PPI scoring because the 2012 standards are of higher relevance than the previous sets of recommendations. For the first time, a recommendation specifically addresses a country's ability to implement targeted financial sanctions related to proliferation as laid out under relevant UN Security Council resolutions. Normally, if data were available for only about 30 countries, the PPI would not include this sub-criterion in the total. In this case, however, because of the direct relevance and importance of these post-2012 evaluations, the PPI adjusted its methodology to include the countries in a way that did not punish the other 170 countries. Therefore, the above-mentioned 31 countries were able to obtain extra points (or suffer subtractions) on top of the 110 total possible points if they

[29] Dev Kar and Joseph Spanjers, "Appendix Table 5: Illicit Hot Money Narrow Outflows (HMN)," in *Illicit Financial Flows from Developing Countries: 2004-2013* (Washington, D.C.: Global Financial Integrity, 2015), http://www.gfintegrity.org/report/illicit-financial-flows-from-developing-countries-2004-2013/. This sub-criterion was modified in the 2018 ranking.

[30] Those countries or entities not included in the CPI but evaluated by the PPI are: Andorra, Antigua and Barbuda, Belize, Cook Islands, Equatorial Guinea, Fiji, Holy See, Kiribati, Liechtenstein, Marshall Islands, Micronesia, Monaco, Nauru, Niue, Palau, Palestine, Saint Kitts and Nevis, Samoa, San Marino, Swaziland, Tonga, and Tuvalu.

were evaluated as largely compliant or compliant (or non-compliant) with the new UN financial sanctions-related recommendation.

Extra Credit indicators:

- Compliant or largely compliant with FATF Recommendation 7 (2012)[31]

  FATF recommendation 7 (2012) refers to implementation of targeted financial sanctions related to proliferation. It states, "Countries should implement targeted financial sanctions to comply with United Nations Security Council resolutions relating to the prevention, suppression and disruption of proliferation of weapons of mass destruction and its financing. These resolutions require countries to freeze without delay the funds or other assets of, and to ensure that no funds and other assets are made available, directly or indirectly, to or for the benefit of, any person or entity designated by, or under the authority of, the United Nations Security Council under Chapter VII of the Charter of the United Nations." A compliant or largely compliant score for R. 7 would allow a country to receive 10 additional points.

- FATF Immediate Outcome (IO) 11: Proliferation financial sanctions[32]

  Immediate Outcome 11 states, "Persons and entities involved in the proliferation of weapons of mass destruction are prevented from raising, moving and using funds, consistent with the relevant UNSCRs." As such, IO 11 also refers to implementation of targeted financial sanctions related to proliferation. It assesses whether persons and entities involved in the proliferation of WMD are prevented from raising, moving, and using funds consistent with the relevant UNSCRs. IO 11 is measured in terms of a low, moderate, or substantial level of effectiveness, where a country only received points for "substantial." Examples of outcomes evaluated by the FATF are concrete actions that have been taken, including investigations and prosecutions relating to sanctions. A substantial rating for IO 11 allows a country to gain five points.

Expert Judgment:

One final modification to the super criterion score resulted from extensive expert discussions. The PPI team considered the fact that there may be missing data relevant to the sub-criteria and experts often have the best, first-hand information about a country performing significantly

[31] FATF, *International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation - The FATF Recommendations*, Paris, France, published February 2012, Updated October 2016, http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf
[32] Financial Action Task Force, "An effective system to combat money laundering and terrorist financing," http://www.fatf-gafi.org/publications/mutualevaluations/documents/effectiveness.html (Accessed November 2017).

better or worse than scored. In some cases, experts judged that a country had received too many or too few points based on real-world knowledge and information.

Impact and Flow Chart of Sub-Criteria:

The PPI assigned a low to high impact for weighting each of the positive and negative sub-criteria. Table 5.1 found in the Peddling Peril Index for 2017, and reproduced at the end of the appendix, shows the flow chart of steps in the evaluation where positive indicators add points, negative indicators take away points, extra credit takes away or adds points, and expert judgment is factored in.

Other Criteria Considered

Institute staff considered additional sub-criteria but were unable to find enough information, so they were not included in the scoring. An example is the extent of training and knowledge of financial officials.

Ideally, the PPI team would measure if a country has access to, and participates in, training and outreach programs relating to proliferation finance. However, information on this topic proved difficult to find. There does not seem to be much international assistance offered to countries wanting to improve proliferation financing prevention. General bilateral trainings to prevent financial crimes are conducted by the United States Federal Reserve System, Department of Homeland Security, Department of Justice, Federal Bureau of Investigation, Department of State, and Department of Treasury. The U.S. State Department has organized regional conferences and specific outreach events for countering FoP training, such as in South Korea and Qatar (2013) and Vienna (2015). The Asia-Pacific Group has also actively holds workshops for its members.

Scoring:

The *Ability to Prevent Proliferation Financing* super criterion incorporates 11 positive sub-criteria, five negative sub-criteria, two extra credit, case-by-case sub-criteria, and finally expert judgment, where countries could receive or lose additional points. The positive and negative sub-criteria are evaluated in terms of low, medium, or high impact. Of the 11 positive sub-criteria, two are considered low impact, seven are medium impact, and two are high impact. They are worth 5, 10, and 15 points, respectively. Of the five negative sub-criteria, four are medium impact and one is high impact. Before extra credit and expert knowledge points, a country could receive a total of 110 points under this super criterion. Because of subtractions, negative scores are possible. This raw score is used later to arrive at a total, weighted score and rank for each country. It is also used to derive a ranking for the country.

Table 5.1. Impact and point adjustment for Super Criterion *Ability to Prevent Proliferation Financing.*

High Impact	**Medium Impact**	**Low Impact**
Positive indicators (points are added):		
FATF R. 2 (2012) 31 (2003) National Coordination	(Un)availability of trade finance	FATF R. 30 (2012) 27 (2003) Law Enforcement Responsibilities
FATF R. 40 (2012 and 2003) International Cooperation / Other Forms of Cooperation	FATF R. 10 (2012) 5 (2003) Customer Due Diligence	Lack of denied parties by US and EU
	FATF R. 13 (2012) 7 (2003) Correspondent Banking	
	FATF R. 26 (2012) 23 (2003) Regulation and Supervision	
	Low cumulative illicit financial outflows	
	FATF and Regional Body Membership	
	FATF Compliance Score	
↓		
Negative indicators (points are subtracted):		
Presence of denied parties by US and EU	2017 State Department List of countries posing money laundering/financial crime concern	
	Worldwide Biggest Black Markets ranking	
	Significant illicit financial outflows	
	Lack of influence of corruption	
↓		
Extra credit (points are added or subtracted on a case-by-case basis):		
Compliant or largely compliant with FATF R. 7 (2012) Substantial level in FATF Immediate Outcome 11		
↓		
Expert judgment (points are added or subtracted on a case-by-case basis)		