

# THE ECONOMIC IMPACT OF FINANCIAL ABUSE, FINANCIAL CRIME AND MONEY LAUNDERING

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***Abstract.** This study provides an overview of economic impact of financial abuse, financial crime and money laundering. It reviews the very limited empirical and indirect evidence on the magnitude of these phenomena. Financial system abuses and money laundering induce negative consequences on macroeconomic performances and economic growth. There is a positive relationship between the volume of laundered money and economic growth because an increase of dirty money volume generates short term economic growth.*

*Financial abuse, financial crime and money laundering also impose welfare losses and have negative cross-border negative externalities. Globalization facilitates financial system abuses, but economic damage can also arise from poor regulatory frameworks.*

*In our opinion these findings could provide a critical judgment and decision support for anti-financial-crimes national system.*

**Keywords:** financial abuse, financial crime, money laundering, economic growth, GDP.

JEL Codes: G18, H28, O17.

REL Codes: 8E, 8K.

## 1. Introduction

Money laundering is an illegal activity through which criminal proceeds take on the outward appearance of legitimacy. Laundering is a necessity for any profit-generating by criminal activities. Without the ability to launder their illicit proceeds, criminals fail because money sustains, motivates and gives them power. Narcotics traffickers, perpetrators of financial fraud, organized crime groups and others invest considerable effort into laundering their illicit proceeds.

Internationally money laundering is most often described as the “turning of dirty money into clean money”. According to Interpol’s definition, money laundering consists in “any act or attempt to conceal or disguise the identity of illegally obtained proceeds so that they appear to

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have originated from legitimate sources”. Generally, the act of conversion and concealment is considered crucial to the laundering process. Perhaps the simplest definition is that money laundering is the process of converting cash, precious assets or other property which is derived from illegal activity, so as to give it the appearance of having been obtained from a legitimate and legal source (Shah et al. 2006).

Money laundering generally involves a series of multiple transactions used to disguise the source of financial assets so that those assets may be used without compromising the criminals who are seeking to use them. Money laundering methods also vary depending on the parties involved, in some cases simple methods are suitable, and in other instances complicated schemes are used.

There are three essential objectives that a comprehensive money laundering operation satisfies: (1) it *converts* the bulk cash proceeds of crime to a less suspicious form, (2) it *conceals* the criminal origins and ownership of the funds and/or assets, and (3) it *creates* a legitimate explanation or source for the funds and/or assets. To realize the greatest benefit from money laundering, criminally-derived cash should not simply be converted to less suspicious assets, but the illicit financing of the assets must be also hidden. The third objective is no less important than the former two and concern the effectiveness of a laundering scheme. It will ultimately be judged by how convincingly it creates a legitimate front for illegally-acquired cash and assets. In short, “money is not truly laundered unless it is made to appear sufficiently legitimate that it can be used openly, precisely what the final stage of the cycle is designed to achieve” (Naylor, 2002).

Although there are many ways to launder money, typical scheme involves three stages: *placement, layering and integration*. Through these processes, a criminal tries to transform the monetary proceeds derived from illicit activities into funds with an apparently legal source.

In the *placement stage*, the launderer places the illegal funds into the formal financial system by using formal banks, high value goods acquisition, properties and assets acquisition etc., in order to remove the illegal funds in a way that allows escaping from authorities’ detection. After placing the funds in formal economy, the launderer will try to conceal the source of illegal money through a process named *layering*. In his attempt to distance the funds of their illegal origin and to create confusion, the launderer will set up multiple financial transfers and transactions. In the *integration stage*, the launderer reintroduces the funds back into the formal economy. He will invest his money in real economy by using all the possible methods to bring the funds legitimacy.

Some authors (Schneider, 2004) consider that the final stage of the process involves *repatriating* the laundered funds into the hands of the criminal entrepreneur, ideally with a legitimate explanation as to their source, so that they can be used without attracting suspicion.

Money laundering can occur practically anywhere in the world. Generally, money launderers tend to seek out areas in which there is a low risk of detection due to weak or ineffective anti-money laundering programs. But launderers usually prefer to move funds through areas with stable financial systems because the objective of money laundering is to get the illegal funds back to the individual who generated them. This activity may also be concentrated geographically according to the stage the laundered funds have reached.

## **2. Money Laundering in Romania: Nature and scope**

We have examined all relevant documents contained within the relevant dates in order to identify as much information as possible on the predicate criminal conspiracy, how the criminal proceeds were disbursed by offenders, and any money laundering techniques used. This data generally came from reports prepared by Romanian National Office for Prevention and Curbing Money Laundering. Other police documents that proved useful for this study included court transcripts, investigative progress reports, court briefs, intelligence reports, and “statement of facts”.

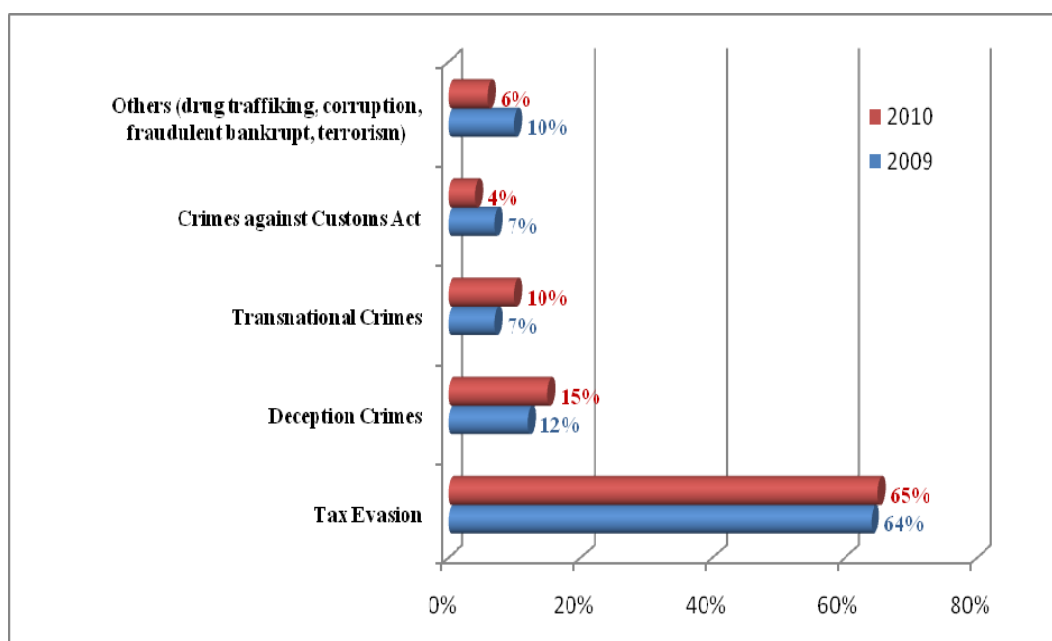
Certain factors conspired to potentially limit the reliability of the data and the ability to extrapolate the research findings to the broader universe of money laundering in Romania. These limitations are the result of the inherently secretive nature of money laundering, the reliance on law enforcement cases as the primary source of data.

Dirty money is generated through various activities such as: frauds, tax evasion, deception crime, transnational crimes (under/over invoicing foreign trade deals to accumulate wealth abroad or change black money into white money), crimes provided by Customs Code, drug trafficking, corruption and bribery, fraudulent bankrupt, crimes provided by Law no. 535/2004 concerning prevention and curbing terrorist acts, counterfeiting and cyber crimes.

While there are a myriad of entrepreneurial criminal activities that produce substantial revenues, according to public information, tax evasion represents the largest source of criminal proceeds in Romania. The legislative, economic and social situation has made the proliferation of tax evasion phenomenon possible. This is an important part of underground

economy and it is ubiquitous in all areas of income generating activities. Taxation stimulates the Romanian tax payer's ingenuity determining him to seek and apply different procedures in order to circumvent the law. Romania has also created the necessary and sufficient conditions for tax evasion: instability of tax legislation, inconsistencies and legislative gaps, useless law concerning tax evasion, bureaucratic corruption, but also the existence of a higher fiscal pressure, an unequal relation between taxation and taxpayer real capacity to pay tax obligations.

In 2010, as Figure 1 shows, 65% of cases involved a designated tax evasion as the predicate criminal activity. The second most common predicate offence was committed against the Law on Commercial Companies (deception crimes) 15%, and 10% against the Customs Code and/or the Excise Duty Act, which primarily consists of the highly profitable international trade in contraband, smuggling and drug trafficking.



**Figure 1.** Offences that generated the proceeds of crime.

**Source:** Annual Activity Reports of National Office for Prevention and Curbing Money Laundering (2009, 2010) and own calculation.

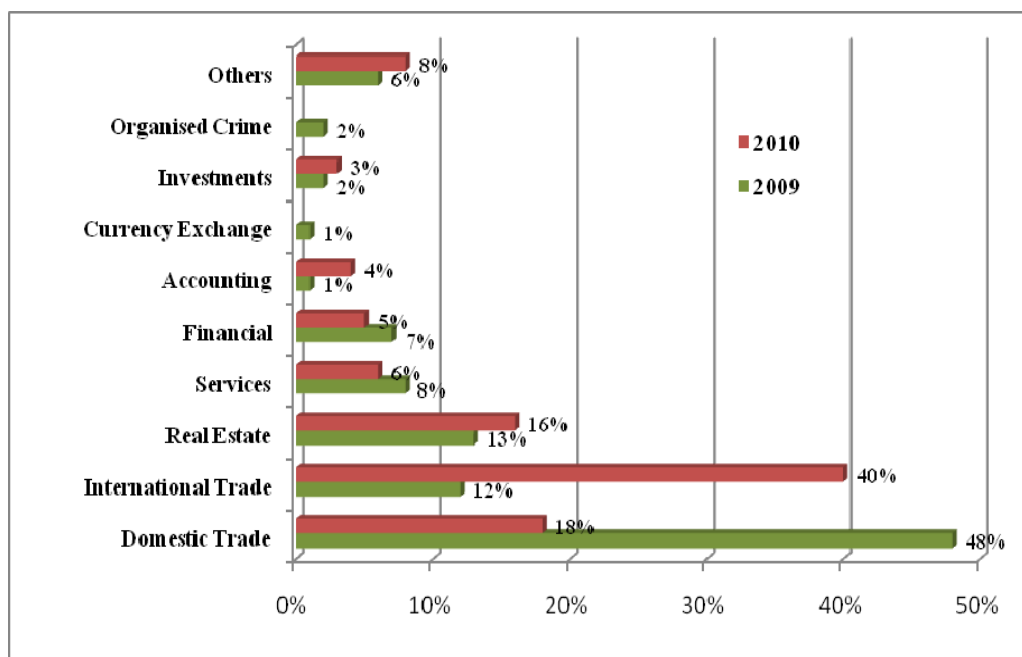
In the course of a single money laundering operation, a number of different sectors are often used. Moreover, when used for money laundering purposes, these sectors are not mutually exclusive, but interconnected: one sector of the economy, such as domestic and international trade, will frequently be used to access other sectors, such as real estate, services and

even other countries (through wire transfers). Others listed are industry, administration, gambling, insurances, leasing, securities etc.

The study findings indicate that criminal proceeds find their way into a number of different economic sectors in Romania. Figures 2 and 3 identify these sectors and the frequency with which each was the recipient of criminal proceeds, based on the public data.

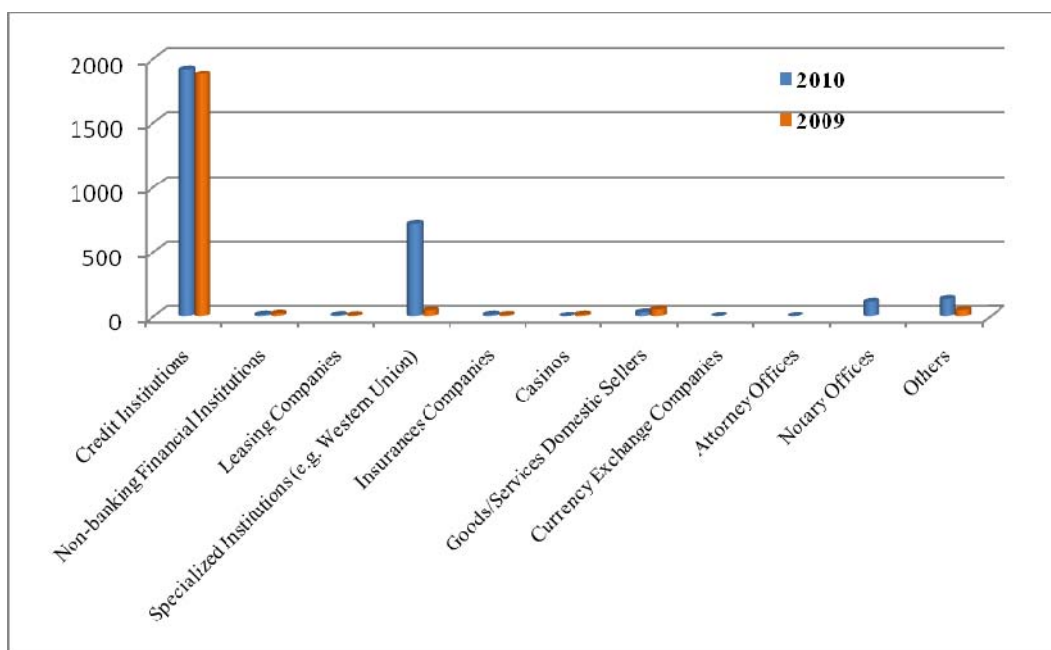
In many of the identified cases, the expenditure of illegally-derived revenues was so lackadaisical and unimaginative that the money laundering objectives and processes laid out above were barely satisfied. In other cases, millions of dollars of criminal funds were proficiently cleansed through elaborate operations that involved numerous economic sectors, dozens of professionals, a myriad of illusory guises and techniques, and hundreds, if not thousands, of obfuscating transactions.

In short, one should not be overly pre-occupied with the term ‘money laundering’. For both analytical and law enforcement purposes, attention should be paid to how the proceeds of crime are disposed by the criminal element – with particular emphasis on how it enters and circulates within the legitimate economy – regardless of whether these transactions satisfy the definition of money laundering.



**Figure 2.** Economic sectors and other assets used for money laundering in Romania (Percentage of all cases).

**Source:** Annual Activity Reports of National Office for Prevention and Curbing Money Laundering (2009, 2010) and own calculation.



**Figure 3.** Formal economy companies used for money laundering: An overview.

**Source:** Annual Activity Reports of National Office for Prevention and Curbing Money Laundering (2009, 2010) and own calculation.

As indicated in the above graph, credit institutions, currency specialized money transfer institutions (e.g. Western Union), companies selling goods/services, and real estate are the four most frequent destinations for the proceeds of crime in Romania. Credit institutions are the single largest recipient, having been identified in 1915 of the Romanian National Office for Prevention and Curbing Money Laundering cases in 2010 (65.47%). While the currency transfer specialized institutions were implicated in almost 25 percent of all cases, in the vast majority, the offender did not explicitly seek out the insurances and leasing companies. In a small number of cases, the insurances companies were used as a financial service provider to launder the proceeds of crime. In these cases, mortgages, investment certificates, life insurance policies, and mutual funds were provided by or purchased from a broker.

Currency exchange companies and cheque cashing businesses were insignificantly implicated. Currency exchange businesses are most frequently used during the first stage of the money laundering process: converting large and conspicuous amounts of cash into less suspicious denominations or alternative currencies. As such, currency exchange businesses constitute a significant portal for the entry of the illicit cash into

the legitimate economy, and by extension represent an important player in the efforts to combat money laundering.

Currency exchange businesses are also attractive to money launderers because they increasingly offer other products and services conducive to money laundering other than currency exchange. These alternative services include wire transfers and bank drafts, among others.

The purchase or sale of goods and services was implicated in 29 cases (1%). Other assets purchased with the proceeds of crime were notary offices (108 cases), jewellery, precious gems, or gold, rare coins, art work, and livestock, including race horses (130 cases). Legalized gambling, in particular casinos and lotteries, were used to launder funds in one identified case.

Money laundering through a casino entails purchasing chips with the cash proceeds of crime and then eventually cashing in the chips for larger denominations of cash or a cashier's cheque. An added benefit is that the proceeds of crime can be claimed as legitimate casino winnings. Some casinos have taken steps to combat money laundering by prohibiting certain cash transactions that could lend themselves to money laundering, such as cash-for-cash exchanges involving small denomination bills for larger denomination bills in amounts over Euro 15,000.

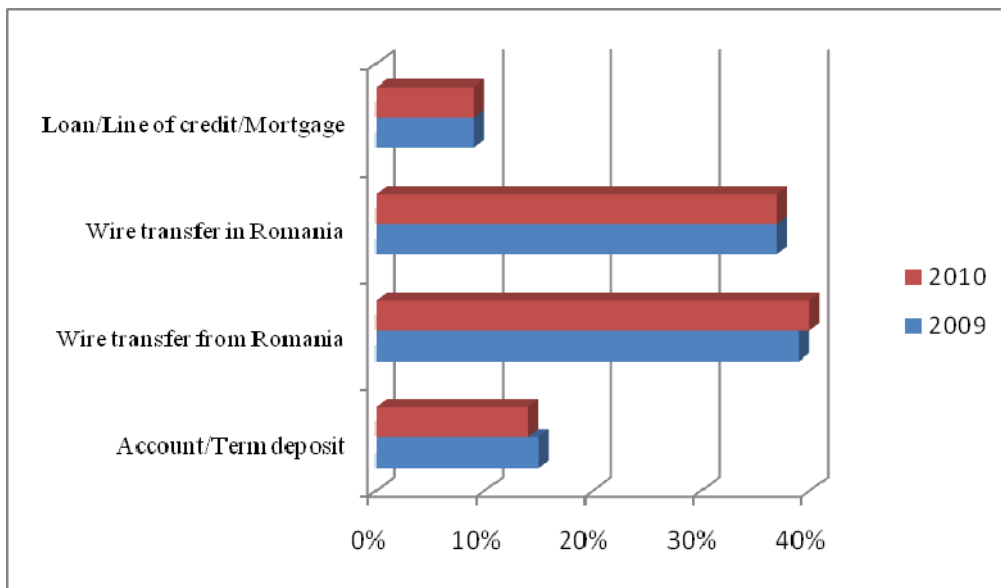
The insurance sector was not expressly sought out by criminals to launder their illicit revenues. Instead, insurance policies were purchased because big ticket items that require coverage – such as cars, homes, and businesses – were acquired (with the proceeds of crime). As such, in most cases, the insurance sector was somewhat tangential to the actual money laundering objectives and processes. In a smaller number of cases, the insurance sector was used much like a bank. As the barriers that separate the different financial sectors continue to tumble in Romania, insurance companies are increasingly providing the type of banking services favoured by money launderers.

The identified cases show that the proceeds of crime were expended in the legitimate economy, not only for personal consumption and laundering purposes, but also to purchase equipment necessary for the continuation of predicate criminal conspiracies, including marijuana cultivation equipment, weigh scales, slot machines, generators, mobile phones and pagers, boats, tractor-trailers, and computers, among others.

Cash was the principal form in which the proceeds of crime entered credit institutions. Combined with the frequency with which they are used to launder the proceeds of crime, this situation indicates that banks

continue to constitute the most foremost entry point for the proceeds of crime into the legitimate economy.

Banks are used more frequently to launder the proceeds of crime than any other single sector of the Romanian economy. Because of their very nature, banks and similar financial service providers are highly conducive to satisfying the objectives of the laundering process. First, they can be used to convert the cash proceeds of crime into less suspicious assets. Second, banking services and instruments, such as cheques, wire transfers, bank drafts, and credit cards can be used to access other laundering vehicles. Third, money laundering techniques intended to conceal the criminal origins of the illicit funds can be used in tandem with banking services, such as registering accounts or purchasing monetary instruments in the names of nominees. Finally, deposit institutions can be used as part of a laundering scheme that creates the perception that the illicit funds were derived from legitimate purposes, primarily by establishing commercial accounts and depositing the proceeds of crime under the guise of legitimate business revenue.



**Figure 4.** Banking products and services purchased/used with criminal revenues.

**Source:** Annual Activity Reports of National Office for Prevention and Curbing Money Laundering (2009, 2010) and own calculation.

Depositing the cash proceeds of crime into a bank account is frequently the first step in the money laundering process and is used to access other laundering vehicles within the deposit institution or other



similar. Bank accounts relieve the criminal entrepreneur of cumbersome amounts of cash, while allowing the funds to be spent, invested, or transferred electronically without attracting the level of suspicion associated with large volumes of cash. As such, a savings or cheque account represents the most common portal through which illegally-derived cash enters a bank and, by extension, the legitimate economy.

Wiring funds is tantamount to sending cash instantly to a different branch, a different bank, and even a different country. Indeed, one of the advantages of a wire transfer for money laundering purposes is that it is not confined within national borders; increasingly, they are used for the express purpose of spiriting illicit money outside the country of origin, whether for money laundering purposes or to purchase drugs or other contraband.

In the context of a money laundering operation, transferring funds between different bank accounts is often used as part of the layering process: to hide the criminal source and ownership of the funds and to obscure any audit trail. In particular, account transfers are used to funnel money into the accounts of nominees, to conceal the connection between the beneficial owner of the funds and their criminal origins, and to pay for supplies and other expenses associated with criminal activities.

While many criminal entrepreneurs certainly have no shortage of cash to invest in real property, mortgages are nonetheless obtained, either to avoid suspicion associated with large personal financing or because the purchaser genuinely requires credit lines. There is also some evidence that criminal entrepreneurs seek out a mortgage to limit their equity in a home, which in turn minimizes their personal financial loss if the property is forfeited to the authorities.

### **3. Professionals in money laundering**

Because most of the money laundering cases involved the use of at least one sector of the legitimate economy, it was inevitable that the launderer or an accomplice came in contact with a professional. When more than one laundering vehicle is used, a number of professionals will come in contact with the proceeds of crime. We refer to those persons with specific skills and expertise who can provide a criminal entrepreneur with specialized services, advice, and access to industry insiders. Lawyers and accountants are the most sought-after professionals, with financial advisors, notaries and insurance agents. Front-line staff of retail businesses that come into contact with criminal entrepreneurs in the course of their

day-to-day money laundering activity, including bank tellers, real estate agents, automobile sales people, currency exchange staff, and jewellery dealers, among others are also favoured.

Professionals could be innocently implicated. They have no knowledge of the source of the funds, or there are any overt circumstances surrounding the money, the client, or the nature of the transaction that would have raised suspicions. However, in some cases the transaction is clearly suspicious, such as the use of large amounts of cash to purchase big ticket items, using multiple bank drafts from different banks to personally finance the purchase of a home, requests that lawyers purchase assets on behalf of a client through cheques issued from legal trust accounts, and the incorporation of numerous companies that carried out no legitimate businesses, yet have significant amounts of cash deposited into corresponding bank accounts. In some cases involving suspicious transactions no reports were made, indicating that the professional was either uneducated on suspicious transactions or was wilfully blind to the suspicious circumstances.

Some of these professionals are concerned to hide the true source and ownership of illegally acquired cash and other assets in order to avoid suspicions that may stem from transacting in large amounts of cash, or to create the perception that the funds were derived from a legitimate source. This is an attempt to hire the direct connection between launderer assets, primarily by registering legal title to the asset in the name of another individual, usually a relative, a friend, business associate, or a lawyer, persons usually unconnected with criminal activities and having no criminal records.

#### **4. Conclusions**

The negative economic effects of money laundering are difficult to quantify just as the extent of money laundering itself is difficult to estimate. The International Monetary Fund, for example, has stated that the aggregate size of money laundering worldwide could be somewhere between 2% and 5% of global gross domestic product. Yet it is clear that such activity damages the financial-sector institutions, reduces productivity in the economy's real sector by diverting resources and encouraging crime and corruption, which slow economic growth, and can distort the economy's external sector – international trade and capital flows – to the detriment of long term economic development. However, the Financial Action Task Force (FATF) notes that it is near impossible to successfully

estimate the percentage of illegal money in the global economy. Nevertheless, countries search to prevent this prevalent issue as governments struggle to rid their economies of illegal funds.

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