



CORRUPTION, SHELL COMPANIES AND FINANCIAL SECRECY: Providing an evidence base for anti-corruption policy

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Authors: This paper was drafted by Tom Shipley based on the research, and unpublished presentations, undertaken by Dan Haberly, Valentina Gullo, Tomas Boukal, Miroslav Palansky, and himself, with Robert Barrington additionally contributing to the writing of this paper. This paper is intended to summarise their research in an accessible format for practitioners; detailed research results and analysis will be published in due course.

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Centre for the Study of Corruption University of Sussex, Falmer, Brighton BN1 9QE
Dr. Dan Haberly, Senior Lecturer in Human Geography
d.haberly@sussex.ac.uk
<https://www.sussex.ac.uk/research/centres/centre-for-study-of-corruption/policy>

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Disclaimer: The views expressed in this report do not necessarily reflect the UK Government's official policies.

List of Acronyms

AML: Anti-money laundering	IFF: Illicit financial flows
BVI: British Virgin Islands	OCCRP: Organised Crime and Corruption Reporting Project
CFT: Combating the financing of terrorism	PEP: Politically Exposed Person
CDD: Customer due diligence	RIFF: Regulation of Illicit Financial Flows dataset
CSO: Civil society organisation	TJN: Tax Justice Network
DEA: Drug Enforcement Agency	UAE: United Arab Emirates
FATF: Financial Action Task Force	
FSI: Financial Secrecy Index	
ICIJ: International Consortium of Investigative Journalists	

Executive Summary

This paper summarises research exploring patterns of global shell company formation and regulations governing offshore financial secrecy.¹ The research uses big data analytics both to examine existing assumptions held by campaigners, practitioners and policy-makers, and to provide an evidence base for future anti-corruption policy-making. The research does two new things:

- i. It conducts detailed statistical analysis of 36,000 company formation events recorded in leaked data from the International Consortium of Investigative Journalists (ICIJ). It shows how these types of datasets can be used to understand how and where shell companies are used by individuals wishing to hide illicit wealth. It also analyses the relationship between political corruption and shell company formation in developing and transition economies.
- ii. It maps the global spread over time of regulations to counter financial secrecy and money laundering through the creation of the Regulation of Illicit Financial Flows (RIFF) dataset. By combining this with the Global Shell Games dataset testing the implementation of regulations, it reveals gaps between the rules jurisdictions have on paper and what happens in practice. This mapping also allows us to pinpoint gaps in the global regulatory regime.

Together this research provides a more secure evidence base than has been available to date for anti-corruption policy related to offshore financial secrecy and shell companies. Key findings are as follows:

- i. A small number of offshore jurisdictions (led by the British Virgin Islands (BVI), Panama, Bermuda and Cayman Islands) play a disproportionately large role in facilitating international business for Politically Exposed Persons (PEPs), who are individuals at higher risk of involvement in corruption. These jurisdictions are connected in chains to international financial centres, such as London, Geneva, Dubai and Miami, where enabling professionals provide services and safe havens.
- ii. Over the last three decades there is evidence of ever greater harmonisation across jurisdictions of standards to counter financial secrecy and money laundering, coordinated by Financial Action Task Force (FATF) standards and its review process. While offshore jurisdictions initially lagged onshore counterparts, by 2015 there was convergence in standards. Implementation gaps between FATF-compliant rules on paper and in practice are widest in Organisation for Economic Co-operation and Development (OECD)-member countries. This is despite these countries having the strongest influence over making the rules and theoretically the most resources available to enforce them.
- iii. The analysis identifies persistent gaps in the global regulatory framework that are of high relevance for countering transnational corruption. From an anti-

¹ For detailed analysis see: Haberly, D., Gullo, V., Shipley, T., Boukal, T., Palansky, M. (forthcoming) 'The "Regulation of Illicit Financial Flows" dataset: A new world map of 30-years of financial secrecy and anti-money laundering reforms'; Haberly, D. and Gullo, V. (forthcoming) 'What drives offshore shell company formation? A time series panel analysis of Panama and Paradise Papers data on developing and transition economy clients, 1991 – 2015'.

corruption perspective, some important areas of reform have been far slower to become established than other measures to prevent money laundering and terrorist financing. In particular, unreformed banking secrecy laws and slow progress in the creation of comprehensive and public registers of beneficial ownership - which hinder the work of both journalists and enforcement agencies – are a continuing obstacle to anti-corruption work. In other words, the global AML system has significant gaps for the purposes of countering corruption.

- iv.** In developing and transition economies, the rate and scale of formation of shell companies is strongly impacted by political corruption. In countries badly affected by political corruption, shell company formation is highest when a regime is stably entrenched in power, and falls during periods of political instability. In these countries, liberalising institutional reforms also increase shell company formation and the risks of corrupt capital leaving a country. While broader macroeconomic factors also influence shell company use, this confirms long-held assertions by researchers that certain reform processes can exacerbate corruption risks if they are blind to the political context. Most disconcertingly, the reforms posing the highest risk in this context appear to be those that aim to strengthen the basic institutional framework of private property rights protection and economic rule of law.

There are three key directions for anti-corruption policy which flow from these findings:

- i.** Since the research suggests that the current FATF-led regulatory review process has major shortcomings in relation to tackling transnational corruption, there is a strong case for more logical targeting of review processes which should:
 - respond to the specific risks associated with the jurisdiction’s function within transnational corruption schemes;
 - emphasise implementation over global convergence of rules on paper;
 - place countries with the largest implementation gaps under greater scrutiny;
 - be conducted at a frequency which reflects a jurisdiction’s importance to global movements of corrupt capital;
 - acknowledge the crucial role played by journalists and civil society in anti-corruption investigations, alongside law enforcement agencies, and assess the extent to which key jurisdictions create undue impediments to this role.
- ii.** Two specific reforms are urgently required to support efforts to expose transnational corruption: publicly available beneficial ownership registers and removing restrictive banking secrecy measures. Analysts need improved sources of beneficial ownership information to be able to understand trends in the activities of networks perpetuating transnational corruption schemes.
- iii.** Good governance reforms may have the unintended consequence of increasing corrupt capital flows. Policy actors working in developing and transition economies concerned about outflows of the proceeds of corruption need to examine how measures they promote could increase the risk of corrupt capital flows. Good governance reforms in these contexts often merge measures aiming to strengthen rule of law and those which liberalise economies. The two should be decoupled, with rule of law being prioritised in contexts where political corruption is highly prevalent. Caution and vigilance are also needed whenever designing and implementing any such reforms, as even attempts to strengthen the rule of law itself run a paradoxically high risk of generating increased offshore company formation in highly corrupt countries.

1

Background to the research

Offshore financial secrecy has become a target for efforts to prevent the flows of corrupt capital (assets derived from, or the proceeds of, corruption) from developing and transition economies. Using offshore leaks data and a newly constructed dataset of regulatory reform, the Regulation of Illicit Financial Flows (RIFF) dataset, this research explores both the changing regulatory landscape and drivers of offshore shell company formation. More comprehensive articles summarising the project methodology, statistical analysis and research findings are available.²

The research is highly relevant to a number of critical policy issues facing the anti-corruption field. While corruption has too often been analysed uniquely within a national frame, researchers and practitioners are paying more attention to the transnational dimensions to the problem.³ This transnational dimension of corruption challenges the narrative that it is principally a problem of the global south. Scrutiny has turned in particular to offshore secrecy jurisdictions and the roles of cross-border ‘professional enablers’, the networks of professionals spread across the international financial system who facilitate and profit from transnational corruption and its proceeds.⁴ Recent work by journalists, civil society organisations (CSOs) and researchers confirms kleptocrats routinely make use of the international financial system.⁵ With kleptocratic regimes on the rise globally, this has brought added urgency to develop effective policy responses.

There remain three significant knowledge gaps which hinder the development of policy responses:

- First, there is a lack of data on flows of corruption proceeds within the international financial system. Occasional exposés of corruption cases give us only partial insights in the favoured routes for channelling corruption proceeds across jurisdictions, the end-destinations for this capital, and the actors involved in these processes.

² For detailed analysis see: Haberly, D., Gullo, V., Shipley, T., Boukal, T., Palansky, M. (forthcoming) ‘The “Regulation of Illicit Financial Flows” dataset: A new world map of 30-years of financial secrecy and anti-money laundering reforms’; Haberly, D. and Gullo, V. (forthcoming) ‘What drives offshore shell company formation? A time series panel analysis of Panama and Paradise Papers data on developing and transition economy clients, 1991 – 2015’.

³ Cooley, A. and Sharman, J.C. 2017. ‘Transnational corruption and the globalized individual’. *Perspectives on Politics*, Vol.13 (3), pp.732 – 753; Heywood, P. 2017. ‘Rethinking corruption: hocus-pocus, locus and focus’. *Slavonic and East European Review*. Vol.95 (1), pp.21 – 48; Mason, P. 2020. ‘Twenty years with anti-corruption – a ten-part series’, <https://www.u4.no/twenty-years-of-anti-corruption-series>

⁴ For an overview of the evidence see Arshinoff, N., Humphreys, J. and Tassé, M. 2022. ‘Global finance and the enablers of corruption’, https://ace.globalintegrity.org/wp-content/uploads/2022/10/GI-ACE_ACT_Global_Finance.v.FINAL_10.19.pdf

⁵ Bullough, O. 2018. *Moneyland: Why the Thieves & Crooks Now Rule the World & How to Take it Back*. London: Profile Books; Cooley, A. and Heathershaw, J. 2017. *Dictators Without Borders – Power and Money in Central Asia*. New Haven and London: Yale University Press; Michel, C. 2021. *American Kleptocracy: How the U.S. Created the Greatest Money-Laundering Scheme in History*. London: Scribe Publications; Transparency International UK. 2019. ‘At your service: investigating how UK businesses and institutions help corrupt individuals and regimes launder their money and reputations’, https://www.transparency.org.uk/sites/default/files/pdf/publications/TIUK_AtYourService_WEB.pdf

- Second, while there is substantial information available on regulatory reform globally, notably through the Tax Justice Network (TJN)'s Financial Secrecy Index (FSI) on which this research substantially relies, this is not available in a form that allows us to understand changes over time.⁶
- Finally, this research confirms that despite intensive regulatory reform efforts by actors such as the Financial Action Task Force (FATF), Organisation for Economic Co-operation and Development (OECD), European Union and national governments, in particular the United States, there is fundamental uncertainty and prevailing scepticism on whether these reforms are having an appreciable impact on stopping flows of the proceeds of corruption.

The research takes some important steps towards addressing these knowledge gaps. It comprises two main elements:⁷

- The construction of the Regulation of Illicit Financial Flows (RIFF) dataset, analysing in detail the changing regulatory landscape in 61 jurisdictions. This is the first time-series panel dataset of regulatory variables relevant to countering IFFs. The RIFF incorporates multiple policy variables of importance to anti-corruption work including regulatory requirements relating to beneficial ownership, client due diligence (CDD) and politically exposed persons (PEPs), alongside different variables capturing other aspects of illicit financial flow policing and financial secrecy. The RIFF covers 61 jurisdictions, selected because of their prominence in offshore leaks datasets, identification in lists of offshore secrecy jurisdictions and/or their broader importance as international financial centres.
- A detailed study of shell company formation showing the location and scale of these vehicles. This time-series study of shell company formation is derived from leaked data made publicly available by the International Consortium of Investigative Journalists (ICIJ).⁸ This data gives exceptional insights into opaque domains of the offshore world where transnational corruption flourishes. Establishing shell company formation as a dependent variable allows for examination of the determinants of incorporation patterns in developing countries, including the role of political corruption. Identification of PEP-linked companies in this data further allows for analysis of patterns of potentially illicit shell company formation.

The research findings which follow are principally relevant to professionals involved in the development and implementation of anti-corruption policies and financial secrecy regulation at the national and international level. The findings will also be of relevance to a range of other individuals working on these themes including journalists and CSOs as well as professionals at law enforcement agencies.

⁶ Financial Secrecy Index, <https://fsi.taxjustice.net/>

⁷ For a full overview of the methodology see Haberly, D., Gullo, V., Shipley, T., Boukal, T., Palansky, M. (forthcoming) 'The "Regulation of Illicit Financial Flows" dataset: A new world map of 30-years of financial secrecy and anti-money laundering reforms'; Haberly, D. and Gullo, V. (forthcoming) 'What drives offshore shell company formation? A time series panel analysis of Panama and Paradise Papers data on developing and transition economy clients, 1991 – 2015'.

⁸ The ICIJ Offshore Leaks Database holds data on more than 810,000 offshore companies which have featured in the Offshore Leaks, Panama Papers, Bahamas Leaks, Paradise Papers, and Pandora Papers. <https://offshoreleaks.icij.org/> (accessed 23 March 2023).

2

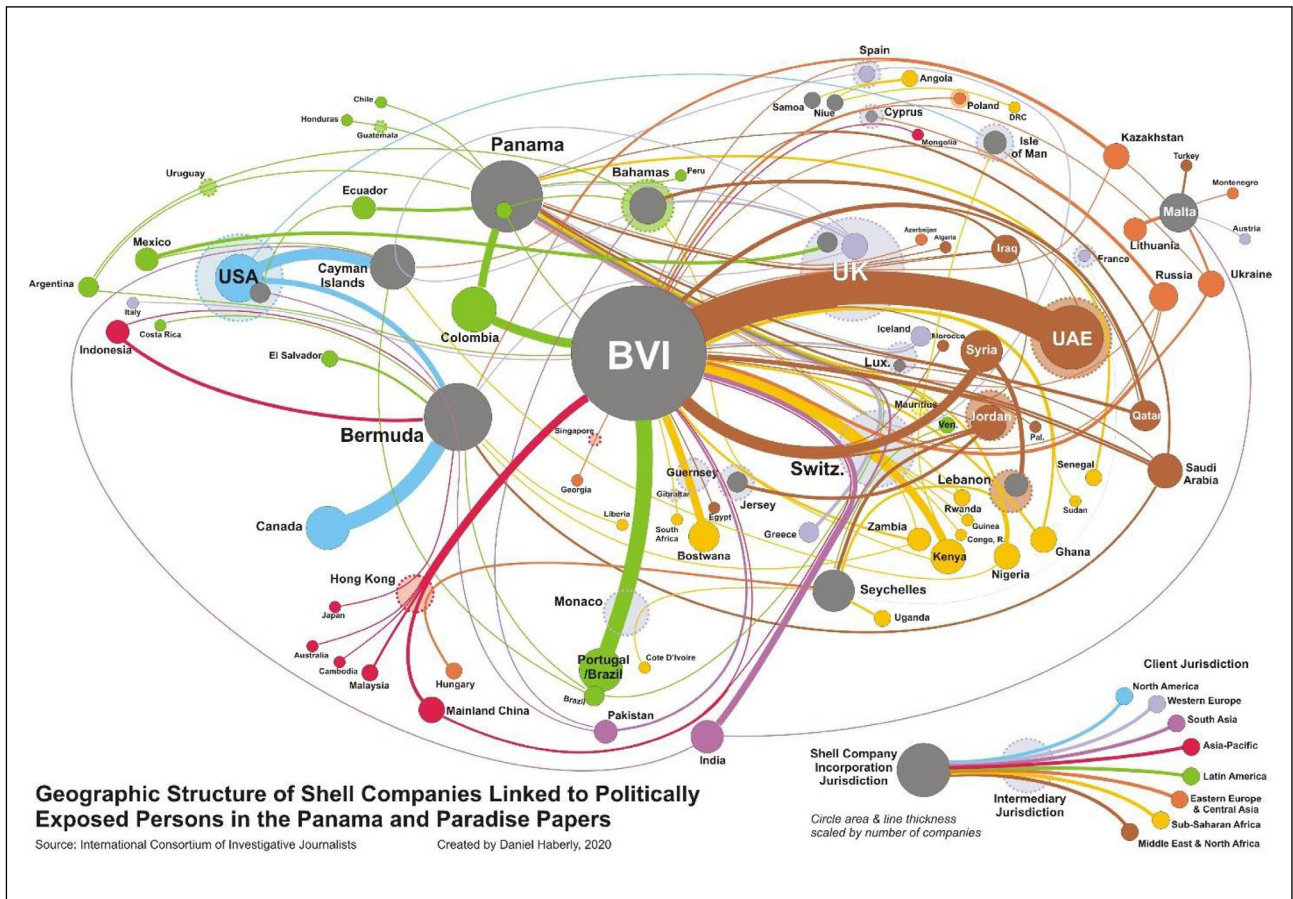
Jurisdictional roles in facilitating PEP business

Using the ICIJ leaked data, Figure 1 below illustrates the geographic structure of all companies in the Panama Papers, Paradise Papers, and Offshore Leaks which have been linked to PEPs by ICIJ journalists. There are three geographic dimensions to the figure:

- Countries which have been colour-coded by region are the locations of clients, the underlying owners or beneficiaries of companies.
- Countries shown in dark grey are the jurisdictions where companies are incorporated.
- The light shaded grey circles depict the major international financial centres where companies are administered.

As the data is drawn from the ICIJ database, it may or may not be currently representative of the global picture; this is, however, the best available information source at present in the absence of such data being made public by the relevant jurisdictions (see section 5 for more discussion).

FIGURE 1: Geographic structure of PEP-linked companies



This visualisation identifies high risk channels for corrupt capital flows and also confirms jurisdictional connections which anti-corruption campaigners have long highlighted. Based on this dataset (which may or may not be representative), a small number of offshore jurisdictions play a disproportionately large role in facilitating international business for PEPs. The British Virgin Islands (BVI), Panama, Bermuda and Cayman Islands, followed by Malta and the Seychelles, are visible as key centres of company formation for PEP clients. Links between specific company formation centres and certain regions are also apparent. For instance, Panama acts as a preferred centre for clients in Central and South America, while Malta fulfils a similar role for clients in Central Asia and Eastern Europe.

Designating offshore company formation centres as the sole locus of the problem in the international financial system would be misleading. Offshore corporate vehicles have value principally because of their place in corporate chains linked to asset markets in developed countries. Administrators in international financial centres are central to helping PEP clients to use these structures, with the UK, Switzerland, UAE and USA visible as principal administrative centres. Again, connections between international financial centres and PEP clients from certain regions can be seen. The UK's role in administering PEP business from the Middle East is clearly visible. The UAE appears prominently as not only a source of PEP business, but also as an intermediary jurisdiction for PEPs from other regions including Sub-Saharan Africa and the former Soviet Union.⁹ Switzerland's role in administering PEP business from Sub-Saharan Africa is also notable in the data.

This research provides geographic evidence to support ongoing debates around the roles of international enablers in transnational corruption.¹⁰ It also aligns with recent research adding nuance to this debate. In particular, Prelec and Soares de Oliveira have designed a framework which positions enabling professionals as working through 'mutually reinforcing layers' divided between upstream and downstream roles.¹¹ This research adds evidence on the likely geographic locations of these actors, firmly discounting a narrative that transnational corruption is a problem geographically confined to offshore financial centres.

KEY POINTS

Plotting the geographic structure of PEP-linked shell companies confirms that a binary classification of onshore versus offshore is unhelpful. We instead need to see these companies as supported by a network of connected jurisdictions which fulfil different roles for PEP clients.

Geographic analysis of historical ICIJ data helps to pinpoint the likely locations of international enablers, although this will evolve over time as networks of enablers adapt to enforcement efforts.

The FATF review process currently applies a uniform approach to reviewing jurisdictions, covering all of the different dimensions of an AML/ CFT regime. This approach does not adequately reflect the varying risks present in different types of jurisdictions that play different roles in transnational corruption.

⁹Page, M. and Vittori, J. 2020. 'Dubai's role in facilitating corruption and global illicit financial flows'. Carnegie Endowment for International Peace. <https://carnegieendowment.org/2020/07/07/dubai-s-role-in-facilitating-corruption-and-global-illicit-financial-flows-pub-82180>

¹⁰For a summary see Arshinoff, N., Humphreys, J. and Tassé, M. 2022. 'Global finance and the enablers of corruption', https://ace.globalintegrity.org/wp-content/uploads/2022/10/GI-ACE_ACT_Global_Finance.v.FINAL_10.19.pdf

¹¹Prelec, T. and Soares de Oliveira, R. 2023. 'Enabling African loots: tracing the laundering of Nigerian kleptocrats' ill-gotten gains in western financial centres'. *Journal of International Relations and Development*.

3

A harmonised global regulatory regime but one with notable holes

Alongside the geographic analysis of ICIJ data, the research traces the story of the global spread of regulation at the jurisdiction level over the last three decades. Figures 2-3 illustrate the increasing stringency of regulation in the key offshore jurisdictions and international financial centres covered by our RIFF dataset.

FIGURE 2: RIFF composite regulatory score 1990 - 2000

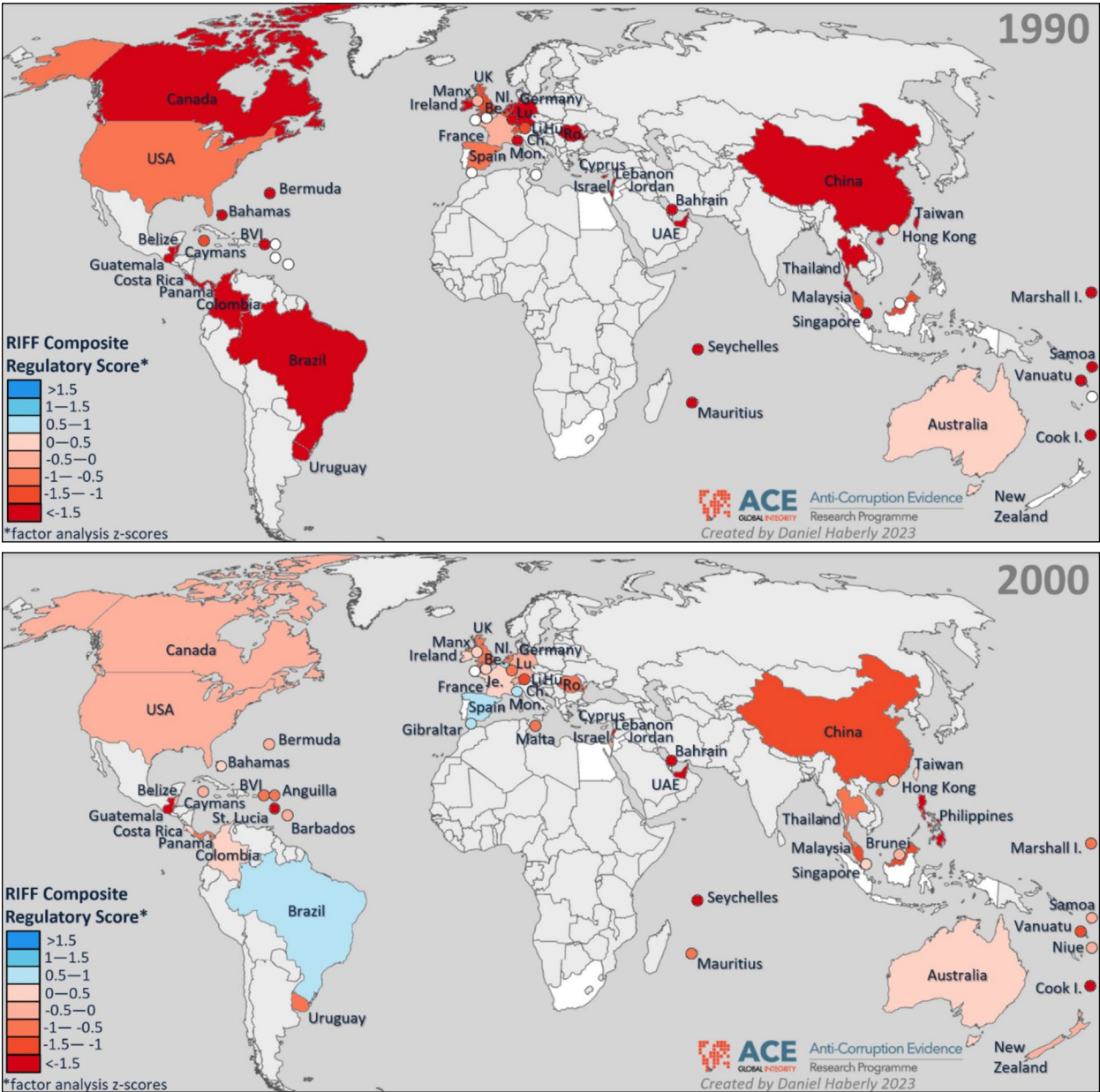
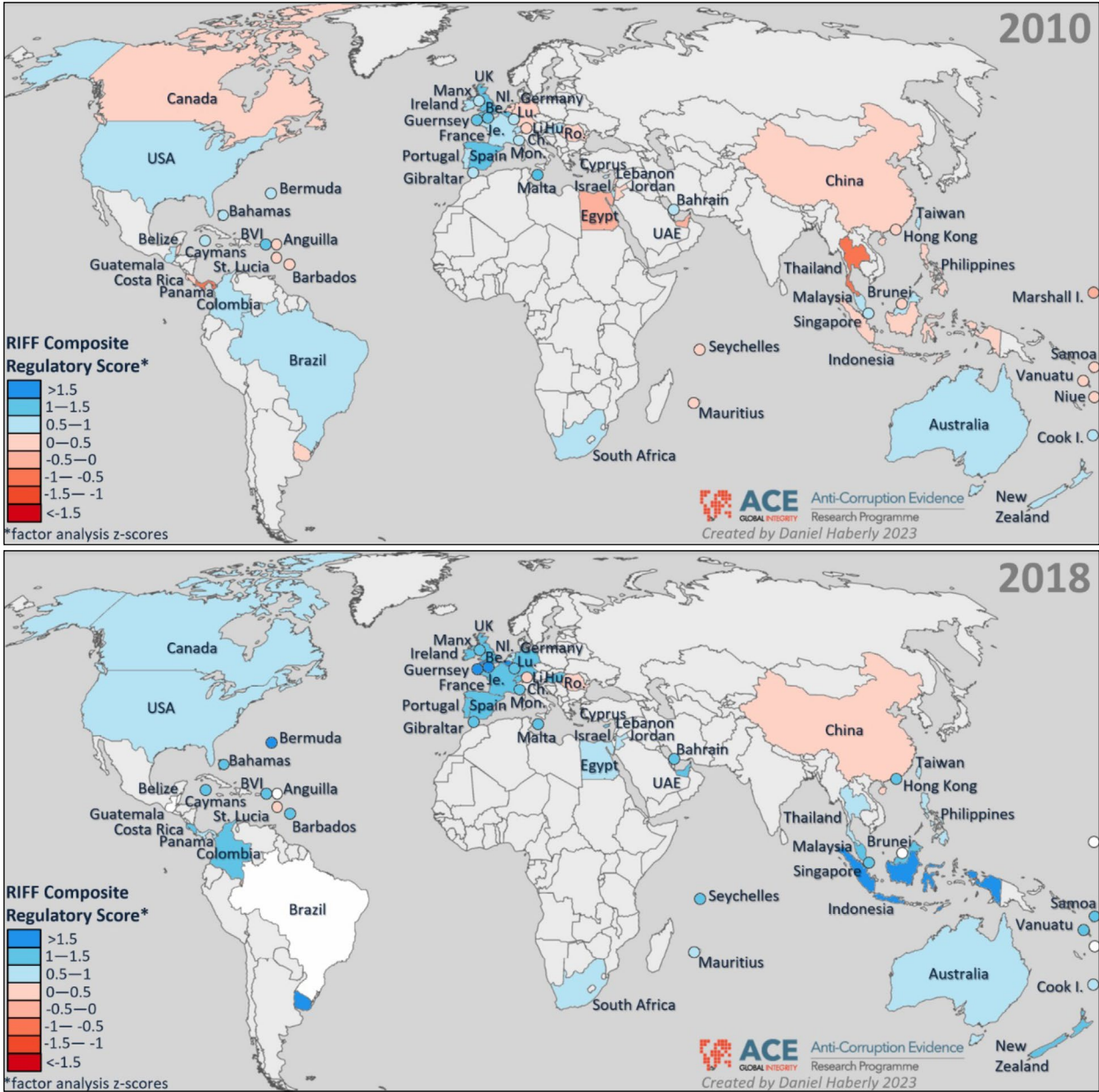


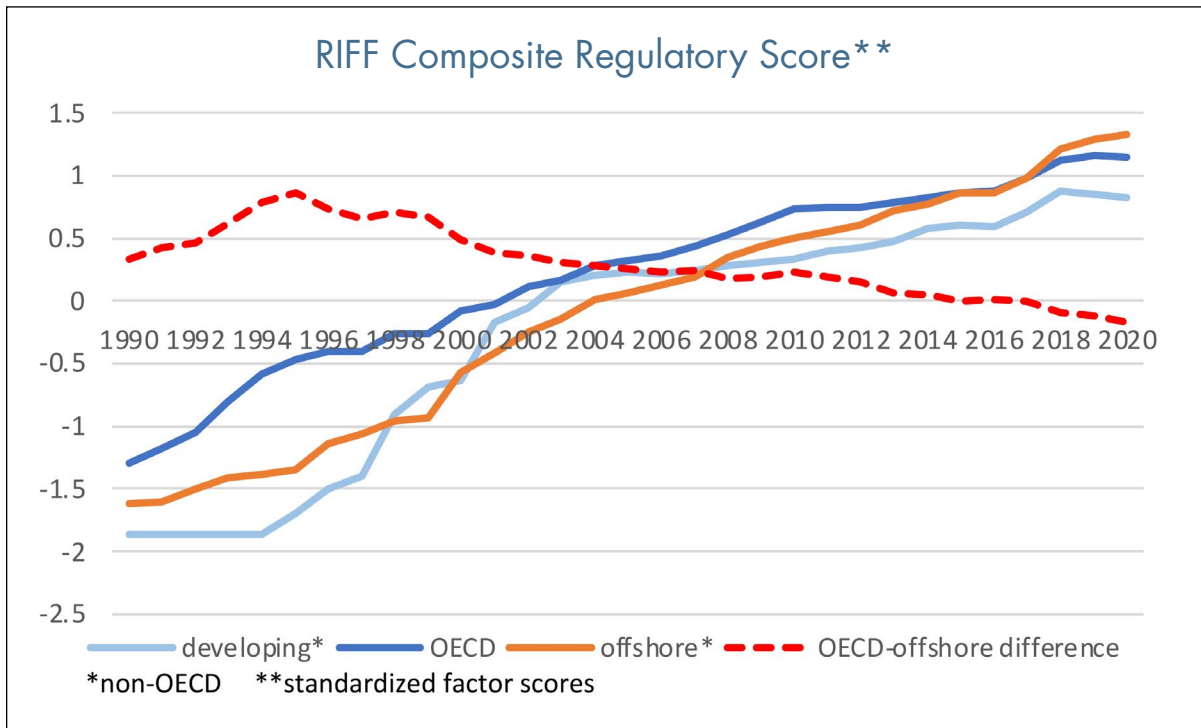
FIGURE 3: RIFF composite regulatory score 2010-2018



Source: Regulation of Illicit Financial Flows dataset

This is a process which begins in the early 1990s and originates in the US through efforts to criminalise the laundering of narcotics proceeds. Its initial spread is concentrated among allies of the US in the developed world, with a major regulatory gap emerging by the mid-1990s between developed ‘onshore’ jurisdictions, and offshore jurisdictions. The emphasis on counter-terrorist financing (CTF) brought additional regulatory requirements for the financial sector in the US and its allies. By 2015, however, on the overall composite index of IFF regulation and financial secrecy, there is evidence of regulatory convergence between OECD member states and non-OECD offshore jurisdictions, suggesting that the latter have in effect caught up in many key areas, as shown in Figure 4 below.

FIGURE 4: Composite score of illicit financial flow regulation by jurisdiction type



Source: Regulation of Illicit Financial Flows dataset

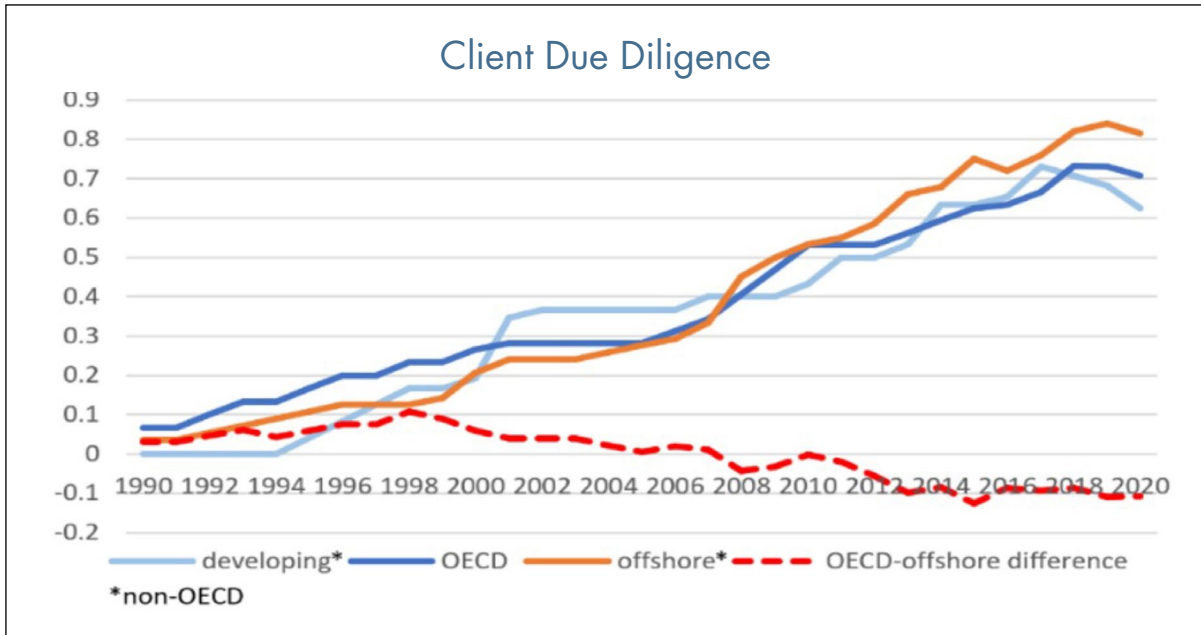
In the context of the ongoing debate around what constitutes success in anti-corruption work¹², the RIFF provides evidence of change, albeit uneven, at a policy level. Over a thirty-year period, important standards relevant to anti-corruption work have been established and diffused globally, at least at the level of nominal legal and regulatory reform. Nonetheless, persistent gaps in the regulatory framework, and wide-ranging questions around the effectiveness of this regime, complicate the idea of success.

On the gaps, certain forms of regulation captured in the RIFF, such as beneficial ownership registers, CDD and enhanced due diligence on PEPs, are priorities for anti-corruption campaigners seeking to prevent the laundering of corruption proceeds. The RIFF shows that the trend across jurisdictions is that both OECD member states and non-OECD offshore jurisdictions have been slower to establish complete legal and regulatory frameworks in these areas as compared to other measures to counter IFFs, with major progress in CDD occurring only after 2007, and beneficial ownership registers becoming widespread only after 2016 (see figures 5, 6 and 7). Requirements for the mandatory registration of beneficial ownership are a particularly recent development, with most countries still lacking a rigorous beneficial ownership registration regime requiring not only the collection of data, but also verification and routine updating of information provided by companies. Notably, as for both general and enhanced PEPs CDD, non-OECD offshore jurisdictions are as a group actually ahead of OECD member states in the implementation of beneficial ownership registers—at least on paper. However, they

¹² See Stephenson, M. 2021. 'Some reflections on the meaning of anticorruption "success"'. Global Anti-Corruption Blog, <https://globalanticorruptionblog.com/2021/11/09/some-reflections-on-the-meaning-of-anticorruption-success/>, and further responses from Barrington, R. 2021. 'Contesting the Narrative of Anticorruption Failure'. Global Anti-Corruption Blog <https://globalanticorruptionblog.com/2021/10/18/guest-post-contesting-the-narrative-of-anticorruption-failure/>

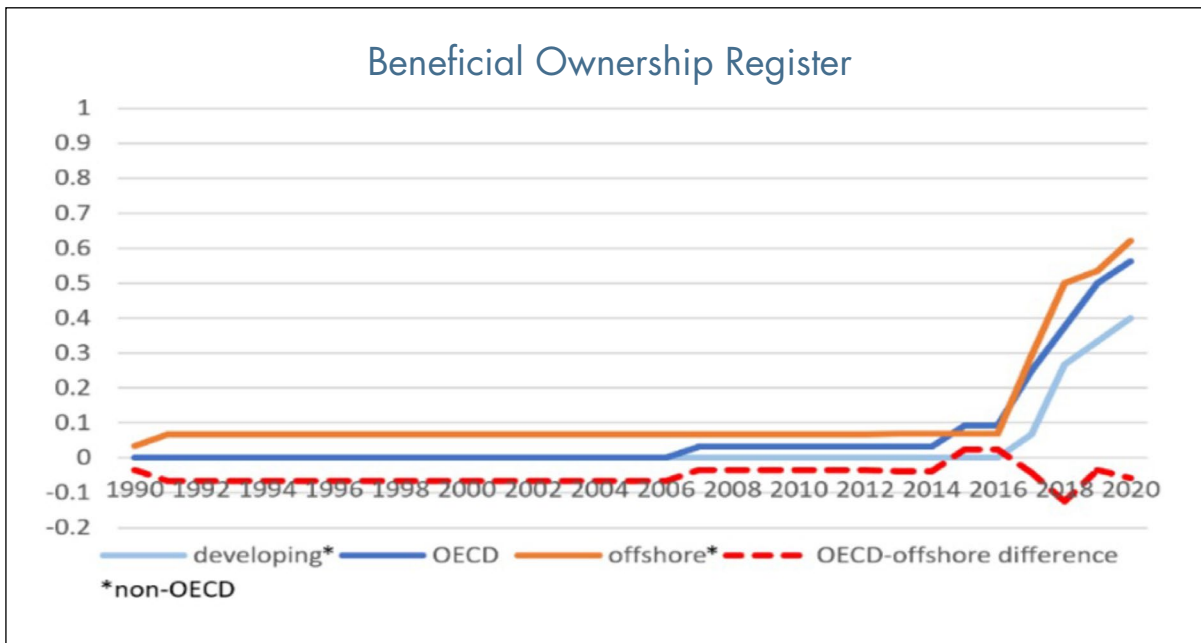
lag behind OECD countries when it comes to making these registers public. Non-OECD offshore jurisdictions also lag behind OECD members in the registration of the beneficial ownership of trusts, which appear to have a growing relative secrecy advantage over other types of legal entities, both onshore and offshore.

FIGURE 5: International trends in client due diligence regulations



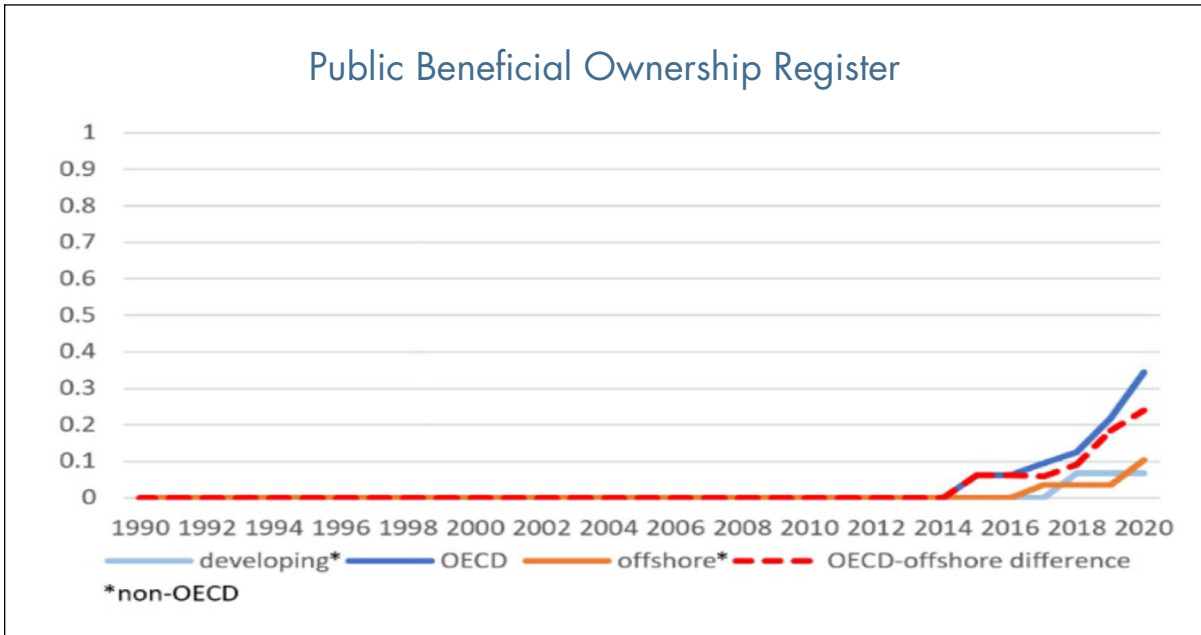
Source: Regulation of Illicit Financial Flows dataset

FIGURE 6: International trends in beneficial ownership register establishment



Source: Regulation of Illicit Financial Flows dataset

FIGURE 7: International trends in public beneficial ownership register establishment



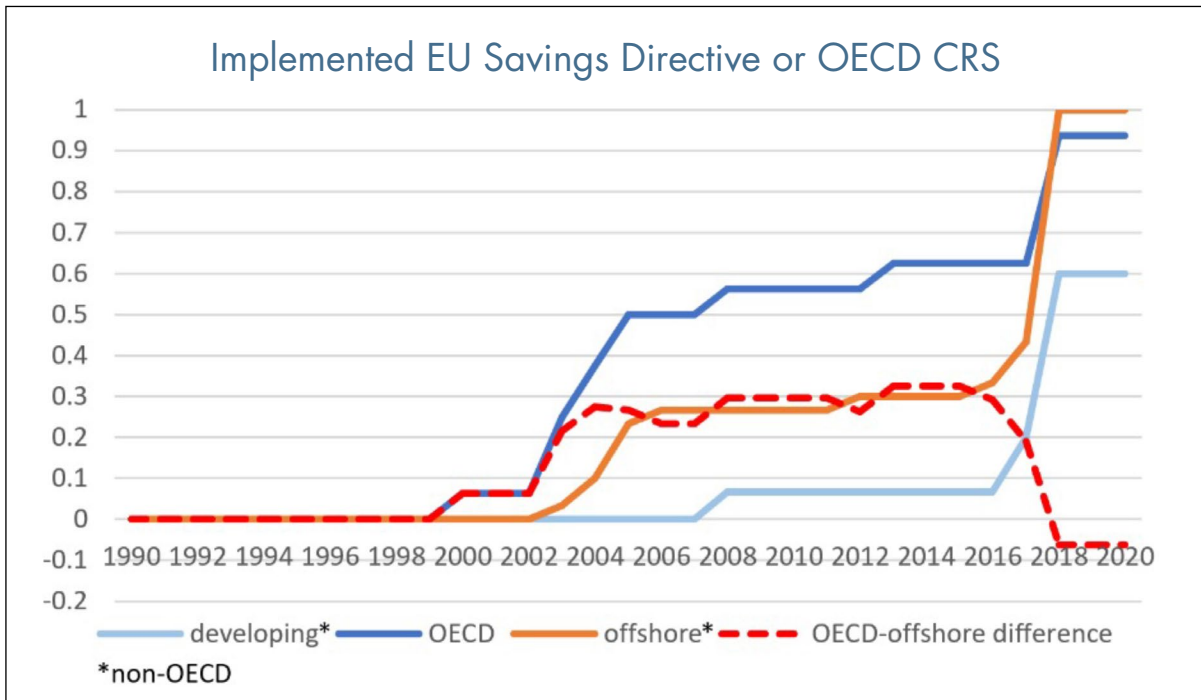
Source: Regulation of Illicit Financial Flows dataset

This consolidation of regulatory indicators for financial secrecy additionally allows us to pinpoint gaps which may hinder anti-corruption work. As noted, the lagging adoption of rigorous beneficial ownership registers globally has made reforms in this area a policy priority for many anti-corruption groups. An issue which receives less attention in the anti-corruption field is the slow pace of reform in banking secrecy. Crucially, recent years have witnessed the expansion of automatic information exchange mechanisms which should in theory, alongside other measures such as enhanced client due diligence, roll back the impact of banking secrecy (figure 8). However, as shown in Figure 9, these reforms have for the most part simply been layered on top of banking secrecy, while the basic legal landscape of banking secrecy itself—often enforced by harsh criminal penalties in the event of breaches—has remained almost entirely unreformed. In other words, what one observes is not so much the repeal of banking secrecy internationally, as the application of various band-aids to it.

Furthermore, in contrast to most areas of reform tracked by the RIFF, where one sees apparent onshore-offshore regulatory convergence, this landscape of persistent underlying statutory banking secrecy remains disproportionately concentrated offshore. This raises the possibility that many offshore jurisdictions may have retained their character as “secrecy jurisdictions” in key respects, even while implementing reforms in areas such as client due diligence and international information exchange. Indeed, we find that the correlation between banking secrecy and RIFF composite regulatory score dropped from 53% in 1995, to effectively zero in 2020, with the international landscape of

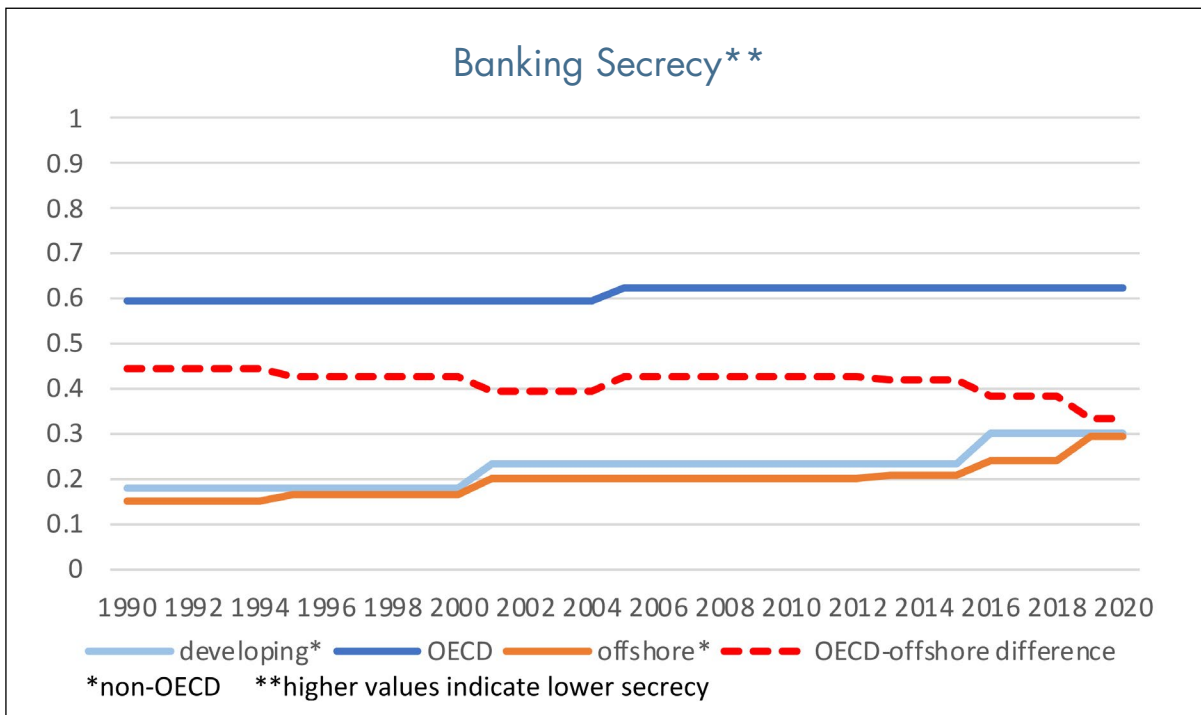
(continued on page 15)

FIGURE 8: International trends in automatic information exchange



Source: Regulation of Illicit Financial Flows dataset

FIGURE 9: international trends in banking secrecy



Source: Regulation of Illicit Financial Flows dataset

(continued from page 13)

banking secrecy thus essentially following the landscape of broader financial secrecy as it existed three decades ago. Figure 10 shows the locations of jurisdictions with partial or full statutory banking secrecy, as of 2018.

FIGURE 10: World map of banking secrecy, 2018



Source: Regulation of Illicit Financial Flows dataset

Reflecting the broader emphasis of the RIFF on capturing the legal landscape of financial secrecy and IFF regulation, the banking secrecy indicator prioritises the existence of either de facto legal or formal statutory criminal penalties for breaching secrecy provisions.¹³ The latter is especially important for CSOs and journalism networks like the ICIJ and Organised Crime and Corruption Reporting Project (OCCRP), which have played a leading role in exposing cases of transnational corruption. It serves as a strong deterrent to whistleblowers with the threat of sanctions hovering over journalists who use banking data in their articles.¹⁴ The fact that the same jurisdictions that maintain statutory banking secrecy also tend to keep any registers of beneficial ownership behind lock and key, away from public access, is likely to impose an additional barrier to attempts by journalists or broader civil society to expose wrongdoing by public figures.

In theory, public authorities should be better placed to overcome these types of access barriers to both banking and beneficial ownership data. In practice, hurdles to the accessibility of data to authorities also obstruct formal investigations into transnational corruption cases. This is an issue compounded when countries have not agreed to the automatic exchange of information, an area where developing countries have struggled

¹³ Tax Justice Network. 2022. Financial Secrecy Index 2022 Methodology. <https://fsi.taxjustice.net/fsi2022/methodology.pdf>

¹⁴ European Federation. 2022. 'Suisse Secrets. Swiss banking secrecy hinders media freedom'. <https://europeanjournalists.org/blog/2022/02/20/suisse-secrets-swiss-banking-secrecy-hinders-media-freedom/>

to secure equal treatment from countries hosting major international financial centres.¹⁵ Furthermore, any restriction of information exchange, or broader transparency, to purely official intergovernmental channels, poses a basic catch-22 for international anti-corruption investigations, by largely reserving the prerogative of investigation for corrupt regimes themselves. These are generally disinclined to air their own dirty laundry, and may even try to abuse intergovernmental information sharing and law enforcement mechanisms to persecute their political opponents across national borders.

KEY POINTS

The RIFF provides evidence of a reformed legal and regulatory framework for combating IFFs; however, there are important gaps which hinder work to prevent flows of corruption proceeds.

The absence of publicly available beneficial ownership registers, as well as persistent banking secrecy laws, obstruct investigative work to uncover and sanction transnational corruption.

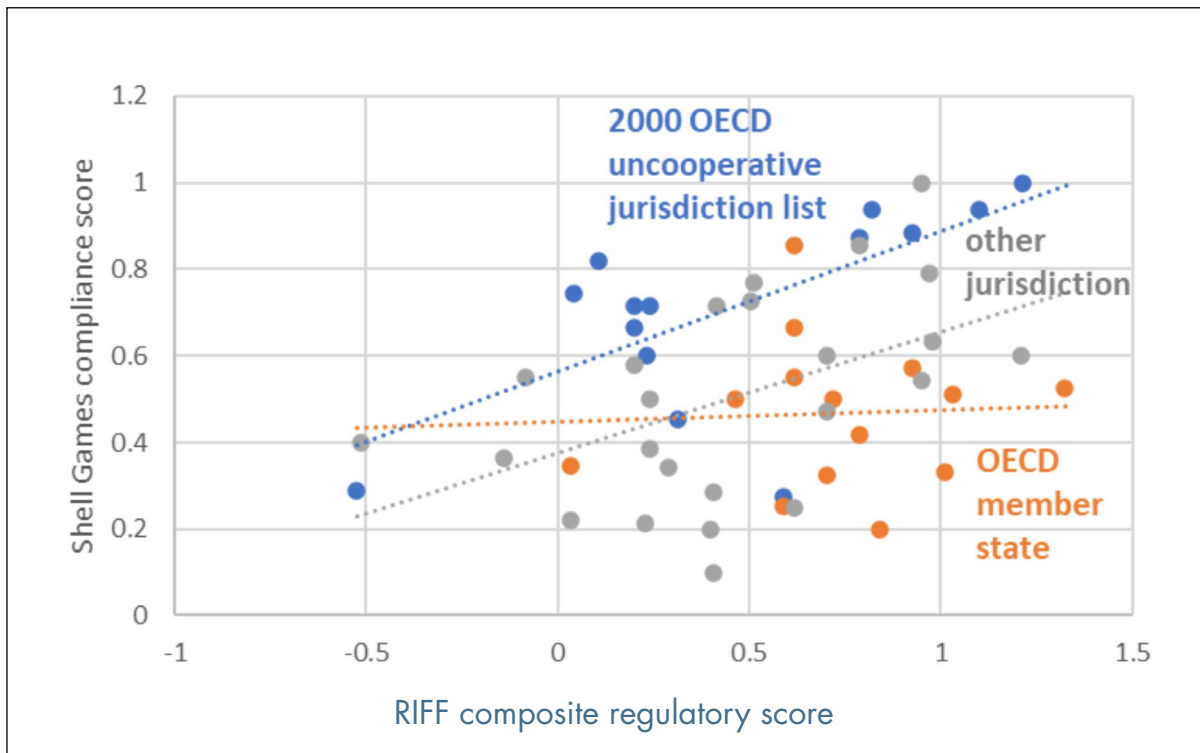
¹⁵ Makortoff, K. 2022. 'How Swiss banking secrecy enabled an unequal global financial system'. The Guardian, <https://www.theguardian.com/news/2022/feb/22/how-swiss-banking-secrecy-global-financial-system-switzerland-tax-elite>

4

Implementation gaps in the global regulatory regime

When a gap exists between the rules a jurisdiction has on paper, and how stringently they are enforced in practice, we can refer that as an implementation gap. It is possible to assess implementation gaps by combining the RIFF dataset with data available from the Global Shell Games project developed by Findley, Nielson and Sharman¹⁶. Global Shell Games tested the effectiveness of international rules on anonymous shell companies, employing a mystery shopper approach to observe whether company service providers complied with measures related to CDD and PEPs among other rules. The fact that these are the same domains that are most heavily weighted in the RIFF composite regulatory score, means that the Shell Games compliance scores can be used to assess the extent to which these regulations are actually translated into practice at the level of financial service providers.

FIGURE 11: RIFF composite regulatory score and Global Shell Games compliance score by jurisdiction type, 2010



Source: Regulation of Illicit Financial Flows dataset and Findley, M., Nielson, D. and Sharman, J. 2012. 'Global shell games: testing money launders; and terrorist financiers' access to shell companies'. Griffith University Centre for Governance and Public Policy.

¹⁶ Findley, M., Nielson, D. and Sharman, J. 2012. 'Global shell games: testing money launders; and terrorist financiers' access to shell companies'. Griffith University Centre for Governance and Public Policy. Available at: <https://www.gfntegrity.org/wp-content/uploads/2014/05/Global-Shell-Games-2012.pdf>

The fact that currently available Shell Games compliance scores are constructed from data collected between 2010 and 2011 means that caution is warranted in extrapolating patterns found here to the present day. However, we find that implementation gaps tended to be, as of 2010, significantly larger in OECD-member countries than in other jurisdictions. Meanwhile, they tended to be smallest in jurisdictions which were historically deemed “uncooperative” by the OECD in matters of international financial transparency and information exchange. Implementation gaps in non-OECD members, which were not deemed to be uncooperative, fell in between these two groups of jurisdictions.

This three-tiered geographic structure of regulatory implementation gaps, that broadly increase in size with a country’s level of development and international political influence, is clearly visible in figure 11. This plots each jurisdiction’s Shell Games compliance score against its 2010 RIFF composite regulatory score, with the relationships between these shown separately for OECD member states (orange), jurisdictions on the OECD’s 2000 uncooperative list (blue), and other states (grey). Shell Games compliance scores are consistently highest, in relation to RIFF composite score, in non-OECD jurisdictions named on the OECD’s original 2000 uncooperative jurisdiction list. Most of these are ‘small island’ offshore jurisdictions, including several UK overseas territories and dependencies. Conversely, a number of OECD member states with high RIFF composite scores show disproportionately low Shell Games compliance scores. OECD states with large implementation gaps include the UK and USA, important intermediary jurisdictions for PEP business highlighted in section 1. The finding is consistent with research identifying significant problems on the effectiveness of regulatory regimes in the UK and US for preventing corruption proceeds from entering their markets.¹⁷

From one standpoint, these findings can be seen as a validation of the effectiveness of the ‘name and shame’ jurisdiction listing approach used by the OECD, as well as by the FATF, to encourage reforms where IFF-related regulations are lagging. However, the fact that the states which have been named and shamed seem to have, as a group, overtaken the states doing the naming and shaming, with respect to the stringency of the implementation of these areas of IFF regulation, is also cause for concern. It is also consistent with the accusations of hypocrisy that have often been levelled against the states leading this reform agenda.

Counterintuitively, we find the effect of OECD membership in this context to be much stronger than FATF membership, despite the fact that these areas of regulation fall more strongly under the purview of the latter. Notably, while FATF’s membership has been expanded to include many large middle income and developing economies, including the BRICS, the OECD remains chiefly a club of wealthy developed countries. Our findings might thus indicate that the latter countries retain most of the influence here, from an observable outcomes standpoint, even if the FATF is an important channel for the multilateral coordination and projection of this influence. The picture varies depending on the jurisdiction, but some common challenges across OECD member countries include under-resourcing and therefore weak capacity of enforcement agencies to investigate and sanction abuses; systems which generate high volumes of information which

¹⁷ Bullough, O. 2022. *Butler to the World: How Britain Became the Servant of Tycoons, Tax Dodgers, Kleptocrats and Criminals*. London: Profile Books; Michel, C. 2021. *American Kleptocracy: How the U.S. Created the Greatest Money-Laundering Scheme in History*. London: Scribe Publications

authorities lack the capacity to review; emphasis on procedural compliance over crime prevention; and a regulatory burden which falls on all customers and can contribute to financial exclusion.¹⁸

There may also be natural limits as to how effective a system originally designed to counter the narcotics trade and terrorist financing can be when it is adapted to fight transnational corruption. We know much more about the profiles of actors involved in transnational corruption schemes, which centre on elites and professional enabler networks and rarely involve the everyday person on the street. This would support the case for much more logical targeting of regulation and enforcement activities than the current system provides for in many OECD countries.

Importantly, the potential shortcomings of CDD and Suspicious Transaction Reporting (STR)-focused regulatory approaches themselves, with their emphasis on procedure as opposed to outcomes, also raises questions about the actual utility of the high performance of offshore jurisdictions in this area. Many of the same jurisdictions which have taken pains to implement due diligence-oriented reforms, at the service provider level, have simultaneously maintained much of the broader institutional infrastructure of financial secrecy. This often includes: preserving statutory banking secrecy, with only limited carve outs for intergovernmental information exchange that are of limited usefulness for policing corruption in developing countries; taking few if any measures to trace the beneficial ownership of trusts; and imposing severe limitations on access to data collected on the beneficial ownership of companies¹⁹. Rather than a generalised offshore-onshore-regulatory gap—in favour of either offshore or onshore jurisdictions—one thus increasingly sees a qualitatively different pattern of issues in each group of jurisdictions.

KEY POINTS

The research shows implementation gaps are widest in OECD member countries, demonstrating the hypocrisy of countries which claim to have strong rules but are not adequately enforcing them in practice.

To effectively counter transnational corruption, the emphasis needs to shift from creating an ever-expanding generalized compliance regime to a more logical targeting of known actors involved in these schemes.

¹⁸ Gilmour, N. and Hicks, T. 2023. *The War on Dirty Money*. Bristol: Bristol University Press; Levi, M. and Reuter, P. 2006. 'Money Laundering'. *Crime and Justice*, Vol.34 (1), pp.289 – 375 ; Levi, M. 2012. 'How well do anti-money laundering controls work in developing countries?' in Reuter, P. (ed.) *Draining development: controlling flows of illicit funds from developing countries*. Washington: World Bank

¹⁹ As of 2019, for example, the British Virgin Islands reportedly restricted full access to its Beneficial Ownership Secure Search System (BOSS) to just two employees of its Financial Investigation Agency. Baker, S. 2019. Sun, Sand, and the \$1.5 Trillion Offshore Economy. Bloomberg (June 3). Available at: <https://www.bloomberg.com/news/features/2019-07-03/the-bvi-s-struggle-to-protect-its-offshore-economy?sref=45uaXh1D> (accessed May 24 2023).

5

Impacts of political corruption on shell company formation in developing and transition economies

The research additionally sheds light on how political dynamics within developing and transition countries affect the use of shell companies. Time-series data on shell company formation at the jurisdiction level can be obtained from the ICIJ leaks. A key finding from the analysis of this data is that patterns of shell company formation are impacted by levels of political corruption at the country level:²⁰

- In countries with high levels of political corruption, there is clear empirical evidence that shell company formation is affected by regime change events, but perhaps in a counter-intuitive way. It might be assumed that regime change would lead to capital flight, and therefore a surge in company formations. However, our results show that regime change only triggers such a surge in countries with relatively low corruption. In contrast, in developing and transition countries with high levels of corruption, shell company formation is higher when a regime is securely entrenched in power, and falls when a regime loses power.
- Liberalising reforms which nominally aim to strengthen legal and property rights have different effects on shell company formation depending on levels of political corruption. In countries with high levels of political corruption, these types of reforms cause shell company formation to increase. This suggests such liberalising reforms can create incentives or opportunities for wealth to be taken offshore. Again, these patterns are not apparent in developing and transition countries with lower levels of political corruption.

This analysis suggests that corruption proceeds are most likely to flow offshore when corrupt political regimes are stable. Data on shell company formation indicates that capital likely leaves over a long-term period of time, rather than a sudden spike occurring following a shift in the political context. In other words, corrupt regimes and their associates are moving wealth abroad from an underlying position of power and security rather than insecurity.

²⁰ The research has used the V-DEM political corruption indicator as a measurement of corruption. However, due to the challenges around measuring year-on-year changes to corruption levels, the research employs a split-sample-based approach wherein each model specification is tested separately on groups of countries. For full discussion see Haberly, D. and Gullo, V. (forthcoming) 'What drives offshore shell company formation? A time series panel analysis of Panama and Paradise Papers data on developing and transition economy clients, 1991 – 2015'.

This is relevant to the timing of certain anti-corruption measures, such as Magnitsky-style sanctions targeted at kleptocrats and asset recovery efforts. Relevant actors such as CSOs and enforcement agencies need to be able to track corruption flows from the point of flight, which is likely to correspond with periods of stability. If this work begins only after a regime's stability or legitimacy has been called into question, after a long period of stable rule, corruption proceeds will already have been diffused and integrated into the international financial system and developed country asset markets. This may hinder efforts to find and recover this capital.

The research also provides evidence to support arguments on the risks associated with economic liberalisation processes in developing and transition countries. The paradox that an agenda of good governance can have unintended or even harmful consequences has long been a concern in the anti-corruption field. Johnston in particular has warned about the dangers of liberalising economies and political systems without essential institutional foundations being in place.²¹ Certain economic measures promoted under the mantra of good governance such as privatisation, deregulation, investment promotion policies, and loosening restrictions on the financial sector, can create opportunities for corrupt actors.

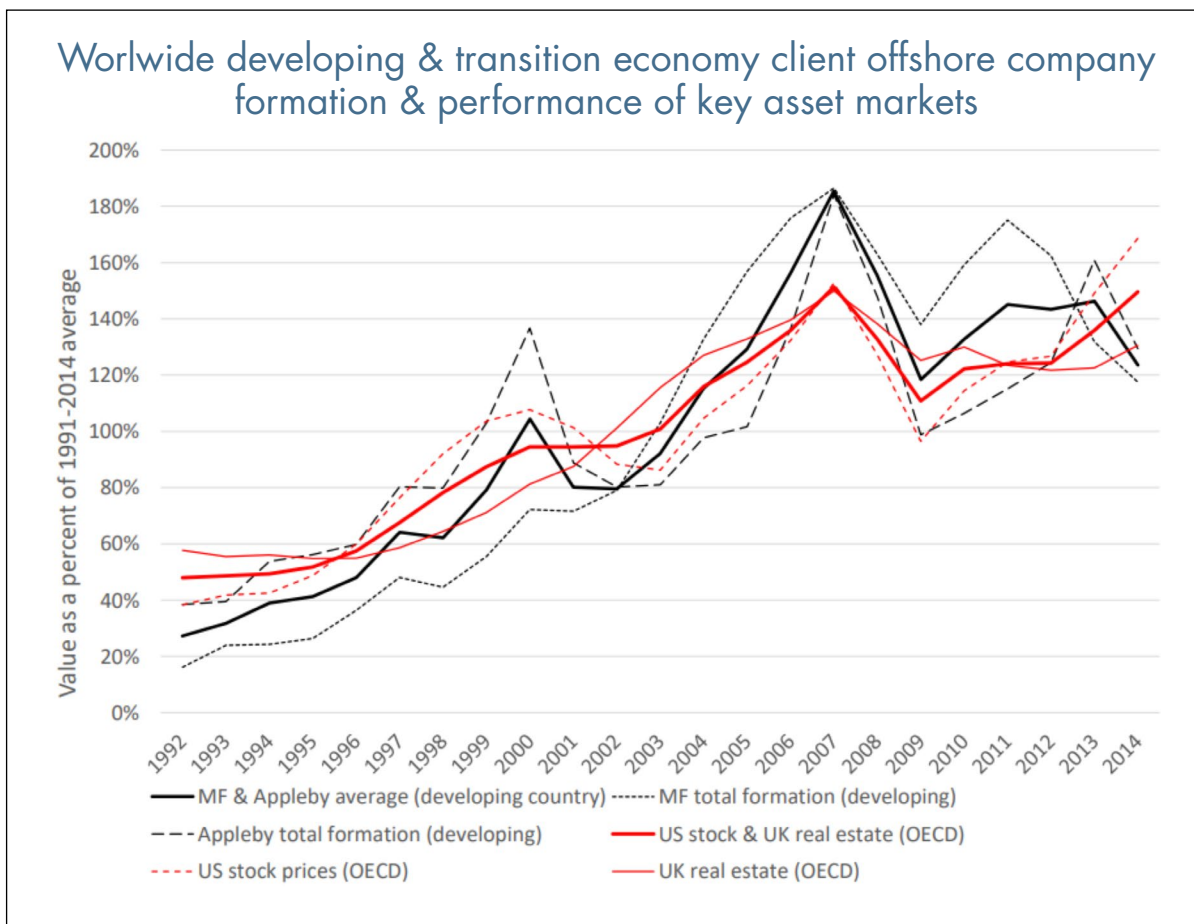
There is a growing body of case evidence which shows how kleptocratic actors across the globe have perverted liberalisation processes for their own economic and political gain.²² These cases are made possible by globalisation and elite connections to western economies intermediated through the offshore world. By examining links between shell company formation and liberalisation reforms, this research confirms the dangers in transplanting reforms from one context to another. The fact that this is a corruption-dependent finding – with increases in shell company formation following liberalising reforms only observed in high but not low corruption countries – shows the importance of understanding the context of political corruption before pursuing liberalising reforms. What is most troubling is that this reform-induced increase in offshore company formation, in highly corrupt countries, seems to be most strongly linked to the apparent strengthening of the basic institutional framework of rule of law and private property rights protection. Attempting to build 'good institutions' in highly corrupt countries thus appears to be something of a catch-22, from the standpoint of offshore wealth transfers.

Notwithstanding these findings, we should avoid a narrative that shell company formation is simply a problem of bad actors in developing and transition countries exploiting loopholes in the international financial system. The research also explored links between shell company formation and broader macroeconomic phenomena, finding that global patterns of shell company formation are more strongly shaped by events in asset markets where wealth is invested, than dynamics within developing and transition economies. Figure 12 shows the strong correlation between shell company formation for clients in developing and transition economies and the cyclical performance of UK real estate and US stock markets.

²¹ Johnston, M. 2005. *Syndromes of Corruption: Wealth, Power and Democracy*. Cambridge: Cambridge University Press; Johnston, M. 2014. *Corruption, Contention And Reform: The Power Of Deep Democratisation*. Cambridge: Cambridge University Press

²² Bullough, O. 2018. *Moneyland: Why the Thieves & Crooks Now Rule the World & How to Take it Back*. London: Profile Books; Burgis, T. 2020. *Kleptopia: How Dirty Money is Conquering the World*. London: William Collins; Cooley, A. and Heathershaw, J. 2017. *Dictators Without Borders – Power and Money in Central Asia*. New Haven and London: Yale University Press

FIGURE 12: Relationship between developing & transition economy client offshore company formation & performance of key asset markets, 1992-2014



Source: International Consortium of Investigative Journalists (Panama and Paradise Papers)

Conceptually we know there are a range of reasons why clients in developing and transition economies may wish to invest in asset markets in developed countries. The research found evidence that a wide variety of cash flows into developing and transition economies, such as mineral rents, development assistance, and IMF crisis assistance, are recycled into offshore jurisdictions.²³ Importantly, while some of this recycling is clearly driven by corrupt actors, its overall scale does not appear to be controlled, for any of these types of inflow, by a country's level of corruption. Rather, it appears to be a default macroeconomic phenomenon operating in countries at all levels of corruption, that results from any artificial injection of foreign currency purchasing power in excess of local investment opportunities. Notably, in some contexts, such as mineral income windfalls, it is actually regarded as sound macroeconomic policy for states themselves to recycle excess capital into overseas markets. Furthermore, for this to be intermediated via shell companies is common rather than unusual practice, with actors in developed countries

²³ For full discussion see Haberly, D. and Gullo, V. (forthcoming) 'What drives offshore shell company formation? A time series panel analysis of Panama and Paradise Papers data on developing and transition economy clients, 1991 – 2015'.

also using similar offshore structures for purposes ranging from tax-neutral mutual fund domiciliation to corporate tax avoidance.

The lesson for anti-corruption practitioners is to not to assume that shell company formation in developing and transition economies is solely driven by elite corruption: there are commonly other broader factors at play which may be more important. Instead, we need to pinpoint which reform processes are most vulnerable to transnational forms of corruption and when these risks are likely to be at their highest.

KEY POINTS

In countries with high political corruption, patterns of shell company formation are predictable. Activity is likely to be at its highest during periods of regime stability.

In countries with high political corruption, economic liberalisation processes increase shell company formation, potentially reflecting increased opportunities for corruption. Good governance reforms in these contexts often merge measures aiming to strengthen the rule of law and to liberalise economies. The two should be decoupled, with rule of law to be prioritised in these contexts.

Shell company formation in developing and transition economies is linked to broader macroeconomic phenomena. We should not assume that this is solely a story of elite political corruption, but rather pinpoint which economic sectors and processes are most likely to be linked to transnational corruption involving shell companies.

6

The case for reinforcing beneficial ownership and other data transparency

Limitations on data and information availability restrict our ability to comprehend contemporary corruption challenges and design appropriate policy responses. Much of this research has only been possible because of publicly available offshore leaks data. Other data sources on company formation do not capture the more opaque domains of the international financial system, nor do they extend back over such a long time period.²⁴ The ICIJ data has led to multiple exposures of suspected transnational corruption cases in jurisdictions across the globe.

Investigative journalists and CSOs have often been ahead of law enforcement agencies in uncovering cases and pushing for sanctions of the individuals involved in these corrupt schemes. More broadly, law enforcement working by itself typically has quite a limited capacity to effectively police corruption, and elite abuses of power more generally, without the supporting and, in many cases leading efforts of journalists and civil society.

To effectively support international anti-corruption work, it is thus crucial that regulatory reforms not simply be designed to enable the investigative efforts of governments, but to also enable the work of these other actors in holding elites to account. At the most basic level, this must entail reforming any banking secrecy or other laws that could potentially criminalize journalists or other whistle-blowers who expose wrongdoing. However, it should also involve enhancing the public sources of data available to support these investigations, so that they do not have to rely on sporadic data leaks.

It is therefore of concern that some of the recent progress we have seen on transparency of corporate information should be under threat. In November 2022 the European Court of Justice issued a ruling invalidating the requirement for public access to beneficial ownership registers as provided for in the 5th EU Anti-Money Laundering Directive.²⁵ Given that we rely heavily on journalists and CSOs to uncover cases, this represents a significant setback to efforts to combat transnational corruption. Mrazauskaite and Stephenson have also previously highlighted inadequacies regarding data collated on PEPs and called for a global PEP database to improve information availability.²⁶

We can expect the networks supporting transnational corruption schemes to continually adapt and mutate. If we are to get in front of these developments, and move away from the largely reactive current approach to countering transnational corruption, it is crucial that that all of the actors which support anti-corruption investigative work—both governmental and non-governmental—be empowered with better data.

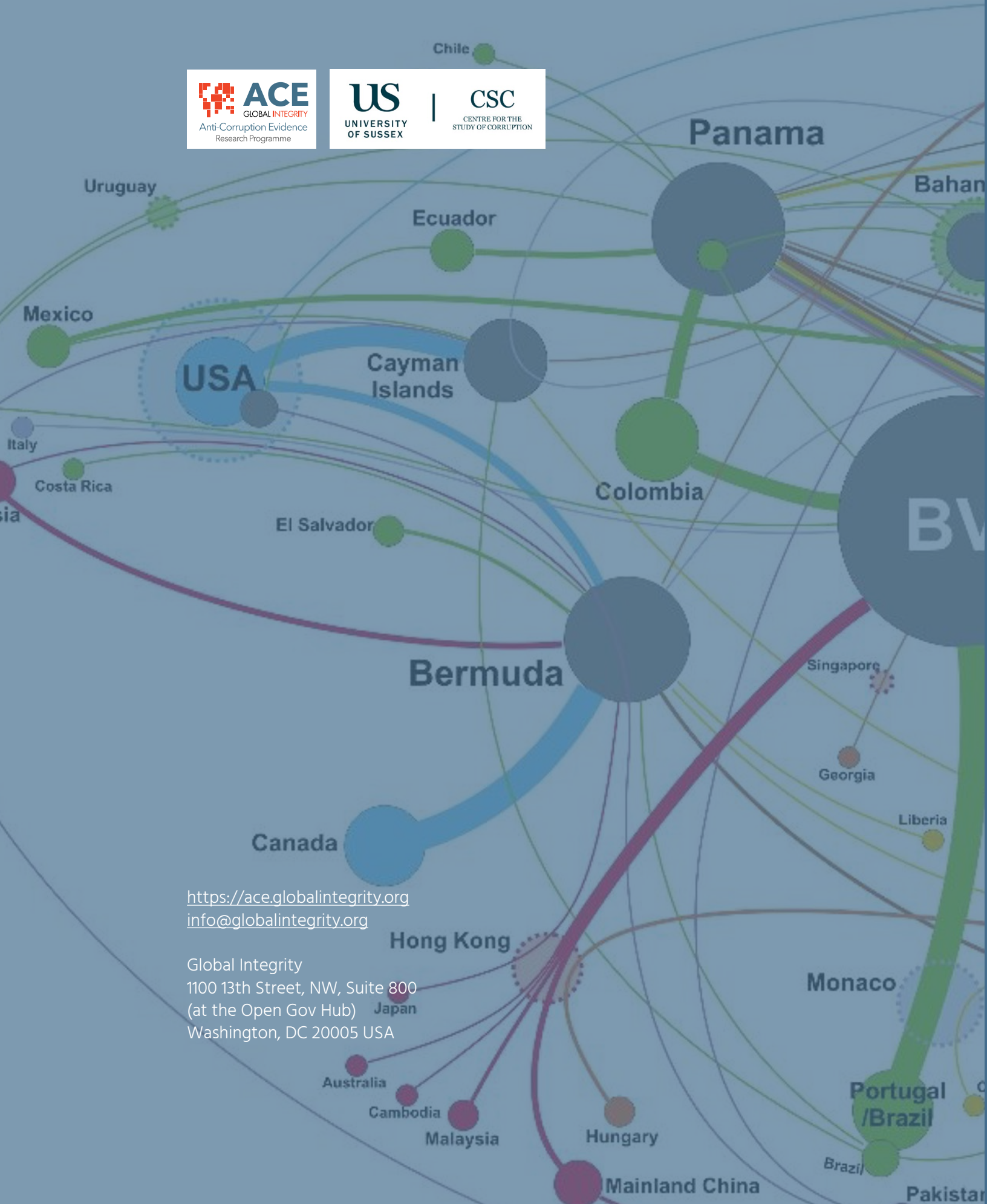
²⁴ For discussion of alternative data sources, see Haberly, D. and Gullo, V. (forthcoming) 'What drives offshore shell company formation? A time series panel analysis of Panama and Paradise Papers data on developing and transition economy clients, 1991 – 2015'.

²⁵ Court of Justice of the European Union. *Judgement of the Court in Joined Cases C-37/20/ Luxembourg Business Registers and C-601/20/ Sovim*

²⁶ Mrazauskaite, R. and Stephenson, M. 2019. 'A proposal for a global database of Politically Exposed Persons'. https://scholar.harvard.edu/files/mstephenson/files/stephenson_mrazauskaite_-_global_database_of_peps_sjil.pdf

Annex

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<https://ace.globalintegrity.org>
info@globalintegrity.org

Global Integrity
1100 13th Street, NW, Suite 800
(at the Open Gov Hub)
Washington, DC 20005 USA