Review of Financial Economics xxx (2016) xxx–xxx

Contents lists available at ScienceDirect

Review of Financial Economics

journal homepage: www.elsevier.com/locate/rfe

Bank secrecy in offshore centres and capital flows: Does blacklisting matter?☆

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ARTICLE INFO

Article history:
Received 16 April 2015
Received in revised form 28 September 2016
Accepted 28 September 2016
Available online xxxx

JEL classification:
F21
K42

Keywords:
Bank secrecy
Offshore centres
International capital flows
Name and shame regulation
Money laundering

ABSTRACT

This study analyses cross-border capital flows in order to verify the existence and direction of the effect of the soft regulation promoted by international organizations against banking secrecy which characterized the so called tax and financial heavens. This effect is called in the literature Stigma Effect, but both the existence and the direction of the stigma effect are far from being obvious. The international capital flows can simply neglect the relevance of the blacklisting, or worst, the attractiveness of banking secrecy can produce a race to the bottom: the desire to elude more transparent regulation can sensibly influence the capital movements. We test whether being included and later excluded from the FATF blacklist is an effective measure that influences countries' cross-border capital flows. Using annual panel data for the period 1996–2014, we apply our framework to 126 countries worldwide. We find evidence that in general the stigma effect does not exist.

1. Introduction

On April 2016 revelations of the Panama Papers spotlighted the role that banking secrecy – which is offered in the so called tax and financial centres and territories – perform in the global economy. The facts have caused increasing concern that banking secrecy lies at the centre of an international web of illegal and criminal conduct. In parallel, several policymakers in advanced countries have emphasised the need for enforcing the blacklisting tool against the territories that breach transparency standards. But does the blacklisting work?

Banking secrecy is an evergreen issue for the national and international debate. In the aftermath of the Global Financial Crisis the fight against bank secrecy as well as against tax and financial havens has become a political priority in advanced countries.

It is often the case that international organisations and national governments do not have strong legal instruments to impose strict measures to prevent and combat banking secrecy. For this reason, soft law practices, such as blacklisting, have been introduced. The aim of the soft law tools is to put the investigated country under intense international financial pressures, using the "name and shame" approach. Under the "name and shame" approach, institutional regulatory organizations and/or national governments disclose names of non-compliant countries and/or non-compliant banks to the public, supplementing the disclosure with forms of official opprobrium (Brummer, 2012). This approach is increasingly applied in the international context and it aims to address policy coordination problems among national policymakers and regulators (Greene & Boehm, 2012).

This paper looks at cross-border capital flows in the period 1996–2014 in order to verify the existence and the direction of the so-called stigma effect, i.e. the effect of the blacklisting in addressing banking secrecy.

Country compliance with the international standards of the blacklisting policy named Anti-Money Laundering and Combating the Financing of Terrorism – **AML/CFT** thereafter – gained momentum in the national policymaking all around the world in the last two decades.

Established by the Financial Action Task Force (**FATF**) in 1999, nowadays the international standard consists of 49 Recommendations, dealing respectively with anti-money laundering (forty recommendations) and combating terrorist financing (nine recommendations). Since 2000, FATF has periodically issued lists – **blacklists** thereafter – of Non-Cooperative Countries and Territories (**NCCTs**), which identify the jurisdictions that FATF believes to be non-compliant with international best practices.

☆ The research has been supported by the Baffi Carefin Centre, Bocconi University. The authors warmly thank the anonymous referees for their constructive comments and useful insights on earlier drafts. Donato Masciandaro pleasantly acknowledges that acting as Consultant for the Inter-American Development Bank has been a unique and precious experience to enrich his knowledge on how the blacklisting process concretely interacts with the financial dynamics. The usual disclaimers are applied.

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http://dx.doi.org/10.1016/j.rfe.2016.09.005
1058-3300/

In order to prevent and combat illegal financial flows, international organizations do not have hard legal commitments at their disposal; therefore they resort to blacklisting by FATF as a soft law practice. The aim of the listing procedure is to put Black-Listed Countries (**BLCs**) under intense international financial pressure, by employing the "name and shame" approach in order to produce the so-called *stigma effect* (Masciandaro, 2005, 2008). The stigma effect represents an inverse relationship between blacklisting and international capital flows. Indeed, the event of being blacklisted decreases the international capital flows towards a country. Two sources of pressures on the BLC are expected to work.

On the one side, most countries that interact with a BLC evaluate its financial transactions as suspicious. This occurrence leads to more stringent and costly monitoring procedures. Banks operating in multiple jurisdictions are the most concerned by these **monetary costs**, including compliance costs. The AML/CFT cost of compliance seems to continuously increase, at an average rate of about 45 per cent (KPMG, 2011).

Along with monitoring costs, financial transactions with a BLC can imply **reputational costs**. Suspicious financial transactions attract more and more attention from supranational organizations, national policymakers and regulators, and international media. For banking institutions, engagement in opaque financial transactions can increase reputational risks. Just to cite some recent and meaningful episodes, it is worth mentioning that in 2012-15 various international banks have been investigated for alleged illicit financial transactions and fined, or solicited, to improve their compliance (Powell, 2013). Transactions with BLCs can produce such a kind of negative reputational effects.

Because of the potential damage caused by the stigma effect, international banks may have a strong incentive to avoid business with BLCs.

In the same way, the stigma effect can be considered as a consequence of the "name and shame" approach.

However both the existence and the direction of the stigma effect are far from being obvious. As it was pointed out in previous studies – (Masciandaro (2005, 2008) and Masciandaro, Takats, and Unger (2007) – the AML/CFT non-compliance of a country can be attractive under specific conditions, such as the potential existence of a worldwide demand for non-transparent financial transactions. A BLC can be attractive for banking and non-banking institutions seeking to promote lightly regulated products and services to their wealthy and/or sophisticated clients. The international banking industry as a whole can have incentives to take advantages from the existence of BLCs.

Therefore the stigma effect, meant to be "a stick" for all the countries not in compliance with the regulation, can turn out into "a carrot".

The *stigma paradox* can emerge. A specific case of regulatory arbitrage that creates the so-called "race to the bottom" strategy, which implies the desire to elude more prudent regulation (Barth, Caprio, & Levine, 2006) and that can sensibly influence the international capital movements (Houston, Lin, & Ma, 2012).

Finally, a third possibility has to be considered: the behaviour of the international banking institutions in the cross-border business can be simply driven by factors other than the stigma effect (Kudrle, 2009). In this case, the *stigma neutrality* holds.

The relevance of the stigma effect has become increasingly important in recent times, when policymakers, regulators and scholars seek to understand which institutional, regulatory and historical features can attract or discourage international capital flows (Papaioannou, 2009; Reinhardt, Ricci, & Tressel, 2010; Houston et al., 2012; Qureshi, Ostry, Ghosh, & Chamon, 2011; Milesi Ferretti & Tille, 2011; Chitu, Eichengreen, & Mehl, 2013). The financial effects of regulation are particularly relevant when the AML/CFT rules are under discussion.

This paper aims to empirically evaluate the trend, magnitude and robustness of the stigma effect, by focusing on the impact of the FATF blacklisting on the relationships between international financial flows and the BLCs banking systems.

So far empirical evidence is sparse and mixed (Kudrle, 2009; Masciandaro, 2013) – with cases of stigma effect, stigma paradox and stigma neutrality being detected – and therefore inconclusive.

To understand the kind of influence that FATF blacklisting can have on BLCs, our research focuses on how international capital flows respond to the stigma signals provided by the FATF. The stigma effect is based on the assumption that blacklisting procedures alter the attractiveness of a country for capital flows. The non-compliance of a country with AML/CFT standards (listing) can decrease the overall amount of financial transactions (volume effect) and/or decrease its efficiency to manage those capitals (cost effect). Of course, the opposite can happen when a country is delisted.

In this paper we aim to find empirical evidence of whether and to what extent FATF blacklisting affects the volume of financial transactions. The stigma effect, as a signal that enables to distinguish between compliant and non-compliant countries, can have deterring effects, since transactions with non-compliant countries imply higher monitoring and/or reputational costs. Observing the signal, international banks allocate their activities accordingly. The effects of blacklisting subsequently manifest.

The rest of the paper is organized as follows. Section 2 contains the review of the literature. In Section 3 we discuss our data and present the identification strategy. Section 4 reports the empirical model and results. Section 5 concludes.

2. Related literature

Blacklisting procedures have been introduced in 2000. Since that time relatively few economic studies on the stigma effect have been produced.

The first theoretical and empirical discussion of the stigma effect as a controversial issue is found in Masciandaro (2005). The study highlight how in the aftermath of 9/11, growing attention has been paid to the role of lax financial regulation in facilitating money laundering and the financing of terrorism (criminal finance).

Two interacting principles are commonly described in the debate on the relationship between money laundering and regulation: a) illegal financial flows are facilitated by lax financial regulation; b) countries adopting lax financial regulation do not co-operate with the international effort aimed at combating criminal finance (International Monetary Fund, 1998; Holder, 2003). These two principles characterize the mandate of the Financial Action Task Force (FATF) for the prevention of money laundering and terrorism finance.

On the one hand, in order to address the problems associated with criminal finance risks, it is fundamental to develop legal standards for regulation. FATF standards (Recommendations) have become the benchmark for measuring the degree of laxity of AML/CFT financial regulation in every single country setting.

On the other hand, faced with the problem of the lack of international harmonization and coordination, the FATF uses a list of specific criteria in order to monitor the compliance of countries with international standards. Those lists of compliance are commonly described as blacklists (Alexander, 2001; Masciandaro, 2005; Verdugo Yepes, 2011). Blacklisting represents the cornerstone of the international regulation, with the effort to reduce the risk that some countries or territories can turn into havens for criminal financial activities. Blacklisting is based on the stigma effect, i.e. the threat for a listed country to face a drop in capital inflows and then the erosion of its competitive advantage after the inclusion in the list (Hampton & Christensen, 2002).

Here the possibility of the stigma paradox occurs. Focusing on the supply of regulation, the study notes that various jurisdictions, notwithstanding the blacklisting threat, delay or fail to change their financial rules, confirming their non-cooperative attitude (*reluctant friend effect*). Furthermore, although the fact that most jurisdictions in the blacklist enact regulatory measures in an effort to be removed from it, it remains to be proven that regulatory reforms are sufficient to guarantee a real change in the country non-cooperative attitude, with a decreasing appeal for black capital flows (*false friend effect*). The existence of these

Please cite this article as: Balakina, O., et al., Bank secrecy in offshore centres and capital flows: Does blacklisting matter?, *Review of Financial Economics* (2016), http://dx.doi.org/10.1016/j.rfe.2016.09.005