



OVERCOMING INSTITUTIONAL GAPS TO TACKLE ILLICIT FINANCING

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The EU legal framework requires that all Member States criminalise the financing of organised crime. According to the provisions of Article 2 (a) of the ***Council Framework Decision 2008/841/JHA of 24 October 2008 on the fight against organised crime*** "Each Member State shall take the necessary measures to ensure that one or both of the following types of conduct related to a criminal organisation are regarded as offences: (a) conduct by any person who, with intent and with knowledge of either the aim and general activity of the criminal organisation or its intention to commit the offences in question, actively takes part in the organisation's criminal activities, including the provision of information or material means, the recruitment of new members and **all forms of financing of its activities**, knowing that such participation will contribute to the achievement of the organisation's criminal activities." Nevertheless, criminal justice authorities in Member States rarely make use of these provisions.

The financing of organised crime is a horizontal issue for all criminal markets, although it rarely falls in the focus of law enforcement agencies. The intelligence gathering of law enforcement agencies has traditionally been focused on uncovering the members of crime groups and tracing the illicit goods or services. Financial transactions are traced mainly for the purposes of money laundering investigations, where the focus is on the proceeds and not on the investments related to the criminal activities. The reason for this is that currently criminal prosecution procedures in all Member States are entirely focused on collecting evidence in regards to possession,

KEY POINTS

- Financing of organised crime is only of marginal interest to criminal justice policies at the EU and Member State levels, although *Council Framework Decision 2008/841/JHA* requires that all Member States should criminalise it and take necessary steps to prosecute it.
- Criminal enterprises, regardless of whether they operate in an entirely illegal market (drugs) or compete in a market with numerous legal players (cigarettes), at some point of their life cycle face many of the same dilemmas and financial limitations that are typical for legal businesses.
- The social capital of criminal entrepreneurs (i.e. their trusted connections and reputation) is more important than the financial capital for entering, operating and succeeding in a given criminal market.
- Along with the criminal proceeds, legitimate sources also play an important role in the financing of criminal undertakings.
- Although criminal economy is known as cash-driven, a great deal of the payment is carried out through the legitimate financial system.



transporting, manufacturing or sale of illicit products or services. Therefore information on the financial aspects of organised crime has been regarded as irrelevant and no deliberate efforts to collect and analyse such data have been made. The quality of financial information collected (when it is collected) is fragmented and compromised because law enforcement agents operating at the local level lack knowledge and experience in financial matters. Financing of organised crime is also often passed over in threat assessments and strategic analyses of organised crime.

The current analysis is an attempt to rectify these shortcomings through providing a different viewpoint on criminal finances and suggesting possible steps toward the introduction of novel approaches to tackle organised crime. The analysis explores topics such as the sources and mechanisms for financing organised crime, settlement of payments, access to financing in critical moments, costs of business and the management of profits. This publication draws on the report 'Financing of Organised Crime'¹, which has been produced with the joint efforts of the Center for the Study of Democracy, the University of Trento and Teesside University and in close collaboration with the State Agency National Security in Bulgaria, the State Police in Latvia and the French National Institute for Advanced Studies in Security and Justice.

Distinctions between financing of legal businesses and criminal enterprises

Criminal enterprises, regardless of whether they operate in an entirely illegal market (drugs) or compete in a market with numerous legal players (cigarettes), at some point of their life cycle face many of the same dilemmas and financial limitations that are typical for legal businesses. **Criminal entrepreneurs may need external financing** under any of the following circumstances:

- to start their business, launch new products or cover new areas;
- to meet recurring financial needs (e.g. purchase of goods, payments to “employees” and contractors, bribes to political or law-enforcement authorities);
- to cover any incidental or, on some occasions, regular expenses (legal expenses, fines, loss or confiscation of goods, restructuring of debts, securing collaterals for certain deals);
- to support the potential vertical or horizontal expansion of their enterprise.

Access to financing in the world of legitimate businesses is directly dependent on the risk associated with each particular enterprise. In an open market, the estimated risk determines the cost of financing and the variety of financial investment and other “resource mobilisation” options available. For instance, outside of fashionable advance technology sectors where huge gains are possible, mature and established companies with proven quality products and services enjoy a lower cost of capital and a greater choice of financial resources in comparison to start-up businesses or businesses without proven track records. Risk is also driven by a number of macroeconomic factors: overall economic stability in a country, reliability of the national financial and legal system, and development prospects for a certain market or industry - all of which may translate into lower costs of capital. For example, manufacturers in Romania or Greece may find it much more difficult and expensive to finance their businesses than similar manufacturers in France or Germany. At a micro level, the cost of financing and variety of sources available are driven by the *expected* ability of creditors and investors to secure the return of their funds – these guarantees include the quality of collateral that businesses can provide and their leverage ratio, but also the efficiency of the respective legal and administrative framework.

¹ Center for the Study of Democracy, Financing of Organised Crime. 2015, Sofia: CSD.

In the world of criminal entrepreneurs, the same correlation between risk and cost of financing may exist, but risk assessment is much more difficult to implement and verify. Financing options are affected by factors such as:

- **Differences in the level of hostility of the environment** in which criminal entrepreneurs operate. In some less economically developed countries with high levels of corruption it is not easy to determine whether it is the licit or the illicit businesses that operate in a more hostile environment.
- The **relative illegality of the product** sold and service provided. For instance, cigarettes constitute a commodity for which there is a very large, receptive market, which involves voluntary transfers and an implicit notion of fair market value, and is, therefore, received well (compared to heroin, for example) by large parts of the population. Similarly, the entrepreneurs operating in the sex market are more widely accepted by the public and the authorities than are entrepreneurs specialising in contract killings.
- Consequently, the **level and extent in which a criminal enterprise is embedded** in the so called “upperworld” – the sphere of legitimate transactions – is also a factor. The more embedded a criminal market is in the upperworld, the easier it is for financial sources to be found (e.g. VAT fraud vs heroin).
- The relative **inability of the illegal entrepreneur to advertise** their business and compete openly.
- **Difficulties in recruiting talent.** Except where there is a plausible lawful rationale for the activity (like for “boiler room” salespeople or for “money mules” through whose accounts money is laundered), criminal entrepreneurs (unlike legal entrepreneurs) cannot legitimately advertise positions and recruit the best employees or collaborators; something that may affect the success and profitability of the enterprise.
- The **range of skills required** create barriers to entry which do not exist in other markets (for example, producing counterfeit DVDs, which is a relatively easy task, as opposed to hunting tigers or elephants for their body parts).
- **Information leaks** by actors related or unrelated to the criminal enterprise (current employees, disillusioned and sacked employees, customers/clients, competitors, family members, etc.). The possibility of information leaks increases the bigger and more successful the enterprise becomes. Thus, criminal entrepreneurs can be the victims of their own success, which is generally not the case with legal entrepreneurs, unless they expand beyond their ability to judge and control their environments, or are unable/unwilling to delegate.
- The **level of violence** of a given criminal market (e.g. though still not as common as popularly believed, Class A drugs trafficking is generally associated with more violence than credit card fraud or the illicit cigarette trade);
- The **priority given by law enforcement** to those participating in a particular market (for instance, hard drugs), and the respective penalties – both perceived and actual – which affect expected and real risks. Real risks affect incapacitation via imprisonment; expected risks affect general and special deterrence via willingness to participate.
- **Differences in the visibility** of the criminal activities themselves. For example, the street-selling of cigarettes vs the street-selling of heroin.
- The **willingness of victims or affected bystanders of a criminal market to take action** and/or report criminal enterprise-related activities to the authorities. For instance, victims of fraud are generally more willing to report criminal activities to the authorities than

are individuals living in an area in which the trade of cannabis is rife.

- The **degree of centralisation of markets** – more centralised markets command better financing options than fragmented markets. This is related to the ability of the criminal entrepreneur to have an overview of the operation and several financial aspects. A study on the financial management of drug crime in Sweden, for example, found that some drug dealers found it difficult to make financial management of drug trafficking more efficient because, in many instances, they were not aware of what all business-related expenses in their scheme were.
- The **ability of the illegal entrepreneurs to use information and communication technologies** (ICTs) to facilitate their business (for example, offline trade in counterfeit medicines vs online trade in counterfeit medicines). Online entrepreneurs require less financing than offline entrepreneurs.
- The **strategies and efforts made by law enforcement authorities**, including frequently mutating technologies against illegal enterprise, and their intended and unintended consequences accounting for the “shifting terrains” that criminal entrepreneurs respond (or attempt to respond) to. Such strategies can have substantial financial implications.

In general, it can be expected that capital in criminal markets is readily available when the potential for profit is high and the perceived risk is low. However, the nature of the criminal enterprise follows from the requirements of continuous criminal transactions, and these transactions depend heavily on how economic, social and cultural relations are articulated in particular national and local contexts.

The criminal sources and mechanisms of financing organised crime

One of the main conclusions of the analysis is that the **social capital of criminal entrepreneurs** – their trusted connections and reputation – **is more important than the financial capital for entering, operating and succeeding in a given criminal market**. Social capital appears to be a precondition for access to all levels in any criminal market. It could also act as a substitute for the financial capital needed to start and operate in a given market, insofar as it can secure access to advance payments from customers or revolving credit agreements from a supplier. This is particularly apparent in drug markets, where revolving lines of credit seem to be commonplace in many countries, especially at retail level and wholesale level. The relatively high profit margins and low production costs may encourage this, since failures hurt opportunity costs rather than fixed costs. The **bigger the level of risks associated with a given criminal activity, the greater the role social capital** plays in entering the market. Within this context, the presence of brokers is paramount for the creation of social capital, since they are the link between two or more parts of a criminal network. In addition, social capital is embedded in occupations, activities and relationships within legal businesses which act as a platform upon which *legal* relationships (i.e. business partners, employer-employee, etc.) transform into *illegal* relationships.

Likewise, upward mobility in criminal markets is not merely a matter of accumulating **financial capital**. **Social capital** is of utmost importance in terms of building a customer base of trusted clients and establishing trusted relationships with suppliers from upper levels. Furthermore, the operations of large-scale importers of drugs, illicit tobacco traders or big VAT fraud ring leaders are also dependent on their **corrupt relationships with government officials**, without which they would not be able to operate on that level and scale. Corruption links can also be viewed as a form of social capital, although

obviously they cannot thrive without steady financial incentives.

As largely expected, **reinvestment of criminal proceeds is reported as the main form of financing** for the criminal operations. However, numerous other forms of financing – both from legal and illegal sources – also exist. In general, purely criminal forms of financing can be classified according to the following three categories: investing proceeds from other crimes or criminal businesses, shared investment schemes and borrowed capital.

Although criminal entrepreneurs do accumulate expertise and specialise in certain criminal markets, **they also readily move their criminal funds to other prospective and more profitable activities**, thereby taking opportunities that might bring higher returns. Examples include proceeds from extortion or loan sharking used to finance drug trafficking, drug trafficking revenues invested in the illegal tobacco trade or VAT fraudsters moving into the illegal tobacco trade. Furthermore, conventional crimes such as burglaries or robberies might be used to secure start-up capital in order to enter drug markets, especially at retail and wholesale level. This is not to suggest, however, that all criminals can and do move flexibly between markets; but if there are no major “discomfort zones” or technical/social obstacles, some do so. Where there are no organisational links available, personality traits or cultural preconditions may play a role, however, they are yet to be explored in detail.

Shared investment schemes seem to be common for all supply chain levels across different markets. This form of financing not only allows criminal entrepreneurs to kick-start a given project when they cannot raise the necessary financial resources on their own, but more importantly it is a tool for sharing business risks. Therefore, it appears to be practised even at very high levels of the supply chain, although

the entrepreneurs at that level can easily provide their own financing for a given project.

Borrowing capital from other criminal entrepreneurs appears to be the least practiced form of financing that is usually used only in critical moments, hence the existence of specialised (“black”) financiers is an exception. Such illicit lending could be obtained rather by other well-established, career criminals in their wider network in virtue of established trusted relationships or through a trusted surety. Further on, it usually requires certain collaterals; these range from valuable assets to giving family members as hostages. In some of the countries studied, loan sharks appear to act as illegal criminal lenders, but only for smaller sums and usually at lower levels of the criminal market.

The legitimate sources and mechanisms for financing organised crime

Along with the criminal proceeds, **legitimate sources also play an important role in the financing of criminal undertakings**. While this is widely contended with regards to terrorist financing, little if anything is known about the use of legitimate funds for organised crime purposes. Legitimate money is invested in criminal markets and this takes place from the retail level up to importation and manufacturing levels. For example, the analysis of the organised VAT fraud also revealed that investment of legitimate funds in tax evasion schemes is common. As the scale of this financing is obviously bigger at the upper levels, this necessitates specific efforts to conceal the origin of the funds. Therefore, various methods for **“reverse money laundering”** are employed, whereby the legitimate funds are turned into cash or channelled through a number of companies in order to obscure their origin. This is most apparent in cases of large-

scale organised VAT fraud schemes, where various bogus and offshore companies and straw persons are introduced into the fraudulent chain to obscure the origin of the funds.

In this respect, it is interesting to compare typical money laundering with reverse money laundering. Classic money laundering usually aims at full legitimisation of criminal proceeds in order to prevent subsequent confiscation in case of investigation and prosecution. Therefore, the process usually involves three stages – placement, layering and integration. Reverse money laundering simply aims at obscuring the link between the origin of the money and the criminal project: therefore, it comprises of placement and layering. There is a need for “full laundering” only when there is a risk that someone would investigate and act vigorously following that investigation.

At the retail or wholesale level of drug and illicit tobacco markets, legitimate funds might come from personal savings, revenues from a legal business of the criminal entrepreneur, loans from family or friends, payday loans, and small bank credits. At higher levels of drug trafficking or illicit tobacco markets, as well as with large scale VAT frauds, such legitimate funds may originate from legal business revenues, EU or national subsidies, and bank loans. Certainly, in some of the cases analysed, obtaining bank loans for initiating or perpetuating criminal operations was linked to corrupt bank officials. At this level also, already laundered funds were reported as possible sources of financing, thus blurring the line between legitimate and criminal funds. **Shared investment schemes in which other legitimate businessmen invest their own legitimate funds for a share of profit were also reported.**

In most Eastern European countries the so called “oligarchs” are an example of entrepreneurs with legitimate businesses that invest legal revenues in the criminal economy; such examples were provided for Bulgaria and the Czech Republic. Typically, these

oligarchs enjoy strong political protection over their business. Given their apparent unscrupulousness, it may not be a surprise that the overlap of legitimate and criminal businesses for this group is the rule rather than the exception, so they often move capital from their licit to their illicit activities and vice versa. They are also a fine example of how **political corruption is an important mechanism for funnelling legitimate public resources to criminal businesses** through privatisation, public procurement or national or EU subsidies. A somewhat similar example in the older member states can be found in Italy, where the mafia families have acquired – through extortion or political corruption – various legitimate businesses, but at the same time continue to invest in organised crime activities.

Legitimate funds are also provided for criminal purposes by established legal entrepreneurs who resort to criminal practices in order to maximise their profits or survive harsh times. This appeared to be more common in the **illicit tobacco trade and organised VAT fraud**, where it is easier to conceal such financial operations through manipulation of tax receipts, although such examples were also provided for the drug trafficking business.

Grey revenues resulting from undeclared labour and various forms of tax avoidance are also among the important sources of financing, specifically in regards to organised VAT fraud. It seems that, a larger share of the grey economy is conducive to greater availability of financing to organised crime: undeclared income can readily be invested even without undergoing any reverse money laundering.

Access to capital in critical moments

The methods used to access capital in critical moments – such as following police arrests of key actors in the criminal network, seizing or loss of

merchandise, freezing or seizing of funds or assets – do not differ much from those used to raise capital for initiating or sustaining criminal operations. However, two forms deserve special attention: the use of contingency funds and the use of quick bridging loans from loansharks.

In many cases **criminal entrepreneurs put aside money in contingency or “rainy day” funds** which are supposed to cover such unanticipated losses and one-time expenses. Such funds are usually kept in cash in safety deposit boxes or deposited in offshore accounts, since quick liquidity is a priority in critical moments. A somewhat similar form, typical for Russian organised criminals, is the criminals’ mutual fund, also known as “obschak.”² This fund is a collective contingency form; money from it covers support for imprisoned criminals and their families, which has the additional benefit (and perhaps intention) of also binding them to the group.

Loan sharks also appear to play a role as providers of quick bridging loans to criminal entrepreneurs in critical moments, especially at the retail and wholesale levels. However, the analysis showed that in most countries their role was confined predominantly to ethnic minorities, whether to reduce the visibility of their operations or as a by-product of strong trust and fear relationships.

The use of legitimate financial system for settlement of payments

In terms of how payments are settled, various methods were identified. Contrary to the widespread opinion about the criminal economy as predominantly cash driven, it seems that this is valid

mostly for the retail and wholesale levels, whereas at importation level the picture is reversed. Even with drug trafficking, where both the product and its distribution are illegal, **a great deal of the payment is carried out through the legitimate financial system** – either through money order services, or bank transactions and recently through virtual platforms and the use of cryptocurrencies, which are gaining momentum from a low base rate. Straw persons, front and bogus companies are used to conceal the source and nature of the financial transactions.

A fine example for the use of the legitimate financial system for settlement of payments related to organised crime activities is the case of the organised VAT fraud. In the beginning of the chain of organised VAT frauds there is usually a legal purchase of some goods or services from a large wholesaler or manufacturer and, therefore, all payments must be carried out through the bank system. This is also the case with the “illicit whites”³ and with the import of raw tobacco from legal tobacco manufacturers producing cigarettes for the illegal market. Some drug trafficking cases also indicate that importers pay their South American counterparts through front companies using the legitimate financial system.

This inevitably necessitates criminal organisations operating at these levels to use a variety of money laundering techniques and simple cash couriers in order to avoid detection of the flows of criminal money. The settlement of payments involves both: (a) reverse money laundering aiming at introduction of the “black” cash revenues into the banking system to initiate new criminal projects and (b) classic money laundering, whereby criminal

² The word ‘obschak’ comes from Russian and means ‘common cashbox’ and is related to the criminal subculture in Russia.

³ Cigarettes legally manufactured in one country only to be smuggled and sold in another country without excise tax being paid

entrepreneurs cash out and invest the proceeds of their criminal operations in the legal economy. These cash-in and cash-out flows are often streamed through offshore branches of international companies, or largely offshore companies that have correspondent banking facilities with major banks. This is especially the case with Western European countries. In some countries malpractices or negligent due diligence of bank institutions in the EU involving corrupt bank officers were also reported. However, the analysis suggests that in general, **law enforcement efforts are mainly focused on the cash-out flows, whereas the cash-in flows are largely neglected.**

Policy implications

The analysis of the costs and profits of doing criminal business pointed out several interesting implications. First of all, the study demonstrated that costs can be used as an **indicator of market entry thresholds** and provide useful information about the start-up capital needed by criminal entrepreneurs to operate at a given level. Given that all countries seemed to experience co-existence of different *modi operandi*, as well as both large-scale and small-scale players at all levels of the supply chain, the market entry thresholds also differ depending on the *modus operandi*.

Furthermore, the analysis suggests that **cost and profit analysis might be useful in estimating the financial and corruption potential of a given criminal group.** Thus it could be instrumental in threat assessments and in setting up operational priorities of law enforcement bodies. It can be also used to predict the effect of increased law enforcement pressure on a specific organised crime activity, since changing risks and opportunity costs prompt criminal entrepreneurs to consider switching to other *modus operandi* or shifting to other criminal activities.

The currently well-developed methodologies for **macroeconomic assessments of the size of criminal markets** – drugs, prostitution, illicit tobacco, missing trader fraud – already provide good estimations of the number of consumers, size of demand and supply, and average prices at the different levels of the supply chain. Comparing such macro data with intelligence data collected by law enforcement about investments, costs and profits of criminal groups or networks from different levels of the supply chain could provide a clearer picture of the number of criminal actors and groups in a given local or national market, and thus help detect yet unidentified criminal players. Furthermore, it can provide more precise estimation of the operational and financial capacities of the criminal players at each level of the supply chain, even at the hard-to-trace higher level actors.

Recommended policy measures to tackle illicit financing

Building on the key findings from the study a set of recommendations at the EU and national level could be proposed.

Policy actions at the EU level

- The European Commission should consider development and adoption of an *EU strategy on financial investigations*. The strategy should invite member states to make parallel financial investigations a routine component of all serious and organised crime investigations and thus complement the existing money laundering investigations and confiscation of criminal proceeds. This would require an upscaling of financial investigation resources.
- The strategy should recognise that the **investigation of finances** – including the financing of crime – is a **basic tool for tackling organised and cross-border crime**. The term “financial investigation” should be used in its

widest sense including the purposes of Article 6(1a) and 6(1b) of the *UN Convention on Transnational Organised Crime* (the “Palermo Convention”).

- The EU strategy should recognise the important role of **grey economy** practices, including those by otherwise legitimate businesses, as well as **political corruption** in financing crime.
- The definition of money laundering as laid down in Article 2 of the 3rd *Anti-Money Laundering Directive* should be extended to criminalise “reverse money laundering” (i.e. provision of legal funds by any means, either directly or indirectly) with the purpose to finance organised crime activities.

Policy actions at the level of member states

- Member states should consider developing **national financial investigation strategies** to counter the finances of organised and cross-border crime which aim, *inter alia*, at ensuring equal status to the investigations of predicate crimes and the investigation of finances that motivate and pay for these crimes.
- National strategies should acknowledge that dedicated trained **financial investigators** should be assigned to tackle organised and cross-border crime alongside ordinary criminal investigators, rather than as an afterthought to see if proceeds are available for confiscation.
- National strategies should recognise the role of **grey economy** practices (including those by otherwise legitimate businesses), as well as

political corruption and protection in financing crime.

- Member states should take steps to insure that offences such as conspiracy and “conduct related to a criminal organisation” as laid down in article 2(a) of *Council Framework Decision 2008/841/JHA of 24 October 2008* on the fight against organised crime, be considered more commonly for cases where prosecutors can show how crime is financed.
- Member states should ensure mechanisms for effective and flexible **cooperation among revenue authorities, customs services and law enforcement agencies** for financial investigations in organised crime cases.

Policy actions at the level of law enforcement agencies

- Law enforcement agencies should consider more effective **use of intelligence for systematic gathering of financial information about the organised crime groups** such as financial flows, investments, costs, profits and settlement of payments with the aim of more effective prevention and investigation of criminal activities.
- Law enforcement agencies should employ **criminal financial analysis** more actively by drawing on the financial data collected and in combination with publicly available macro- and microeconomic data and social research data.