International Institutions and

Indirect Market Enforcement:

Analyzing the Regime to Combat Terrorist Financing

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Abstract

How do international institutions that lack formal enforcement tools punish non-compliance? Existing scholarship suggests that outside of institutional mechanisms, the most effective enforcers may be domestic audiences. In this paper, I offer an alternative theory of enforcement where institutional monitoring sends clear and credible signals to financial actors and markets, which then impose higher costs for capital in non-compliant states. By reducing the financial opportunities available to individuals in non-compliant states, market actors punish non-compliance and serve as indirect enforcers for the institution. The implication of this process is that even absent any legally-binding institutional commitment, states can face incentives to change their behavior. I test this theory through an analysis of the Financial Action Task Force (FATF), a non-binding intergovernmental body that is reportedly highly effective at generating policy change on combating money laundering and terrorist financing. Using a new dataset, I analyze how the FATF's monitoring and blacklisting procedure has generated financial costs in non-compliant states. To address selection concerns, I rely on a natural experiment that uses whether states end up just above a blacklisting eligibility threshold as an instrument for blacklisting. My analysis shows that blacklisted countries are viewed as higher risk and are charged higher premiums for debt.

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1 Introduction

The last two decades have seen a growth in the number of international institutions, but the way in which these bodies enforce compliance remains puzzling. In areas like trade and investment, institutions increasingly rely on dispute settlement mechanisms to enforce agreements. In many others, however, institutional rules and recommendations have no legal authority over members. Yet informal institutions have nonetheless succeeded in making progress in areas as diverse as nuclear safety, endangered species protection, and global finance (Koppell, 2010).

How have these institutions succeeded without legally-binding enforcement powers? IR scholarship tends to be relatively pessimistic on the ability of informal international organizations to induce policy change, attributing compliance to selection bias (Von Stein, 2005; Downs, Rocke and Barsoom, 1996). Recent work argues that domestic actors can serve as compliance monitors and enforce policies through domestic channels (Simmons, 2009; Dai, 2007). In many issues areas, however, there is little domestic constituency for policy change.

Building on work on institutional monitoring, this paper suggests markets as an alternative mechanism of institutional enforcement. Under certain conditions, international institutions can signal information about non-compliance to third-party actors, who shift resources away from non-compliant states. Markets, therefore, become agents of enforcement.[1] Market actors punish non-compliance because the information produced by institutional monitoring affects profit goals, or in the case of individual consumers, signals something about the desirability of particular purchasing decisions.[2]

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[1] Although the focus of this paper is on market enforcement, other types of third parties can also serve this role. International institutions, for example, have used information produced by the Montreal Protocol's Implementation Review Procedures to reward compliers and impose penalties on non-compliant states – something the Montreal Protocol itself has no ability to do (Victor, 1998).

[2] During the SARS epidemic, for example, a World Health Organization (WHO) report about unsafe conditions in several Chinese cities and in Toronto, Canada reduced tourism in these cities, hurting local businesses (Koppell, 2010).

I test this theory of indirect market enforcement using data from the Financial Action Task Force (FATF), an intergovernmental body that makes non-binding recommendations about state policies on anti-money laundering (AML) and combating the financing of terrorism (CFT). Although the FATF has no permanent charter and no enforcement authority, it is widely perceived by policymakers as a crucial counter-terrorism tool and highly effective at generating policy change in states. Using a new dataset that compiles information about AML/CFT policies in more than 170 states, I analyze how a change in the FATF's monitoring procedures – specifically, the introduction of a "blacklist" – led the market to punish non-compliant states. I find that although the FATF's blacklist lacks legal authority or any official enforcement mechanism, financial actors still punish states, deterring deviations.

Selection problems pose a significant empirical challenge for analyses of how international institutions affect domestic policies. States that end up blacklisted are likely to differ in many ways from states that are not listed by the FATF; as a result, analyzing the effect of blacklisting without accounting for selection effects is likely to lead to spurious results or attenuation bias. I address this problem by taking advantage of a natural experiment, by which all countries are automatically eligible for blacklisting when the FATF's evaluation process indicates they have failed to meet 10 or more of FATF's key/core recommendations on combating money laundering and terrorist financing. Using this blacklisting eligibility threshold as an instrument, I show that FATF blacklisting creates financial costs, changing how financial actors evaluate the risk of loaning money or conducting transactions in a blacklisted country. This process creates incentives for states to change their AML/CFT policies and "graduate" from the blacklist.[3]

This paper begins by reviewing the literature on institutional compliance, with particular attention to arguments about monitoring and enforcement. Building on existing work, I

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[3]This paper is part of a larger project that examines how institutional monitoring generates compliance via indirect market enforcement; however, this particular project is focused exclusively on enforcement, not compliance.

offer a new theoretical argument about how institutions that lack official enforcement power may nevertheless be able to punish non-compliance. Section 3 provides background on the FATF, its monitoring process, and the evolution of blacklisting, while Section 4 lays out my hypothesis. Section 5 discusses the data, explains how I operationalize my variables, and addresses the question of selection effects. Section 6 presents empirical analyses and results, while the following section offers a number of robustness checks. Section 8 concludes.

2   Institutional Monitoring and Enforcement

2.1   Existing Scholarship

IR scholarship is mixed on whether institutions can have an independent causal impact on state behavior. Realists argue institutions are mere reflections of power and interests, with little constraining effect on states (Mearsheimer, 1995). In this view, institutions would only be able to promote compliance if states were willing to cede substantial enforcement authority to institutional bodies – an outcome that is rarely, if ever, observed. Institutionalist scholars, on the other hand, highlight how institutions can be both reflective of and determinative of state interests. While states may design institutions in a way that reflects their objectives (Koremenos, Lipson and Snidal, 2001), once the institutions exist, they change state behavior by raising the anticipated costs of non-compliance, altering transaction costs, and providing reliable information (Keohane, 1984).

Scholars suggest institutions promote compliance with international agreements through law and enforcement. Many international organizations are formed on the basis of a charter or treaty, which is legally-binding for states participating in the organization. International law may have a constraining effect on state behavior; since states generally obey international law (Chayes and Chayes, 1993), states will incur reputational costs for violating legal obligations (Keohane, 1984; Simmons, 2000; Simmons and Hopkins, 2005). International

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law may also shape norms of behavior and understandings of what constitutes appropriate action (Finnemore, 1996) or lend legitimacy to institutional rules, increasing incentives for compliance (Hurd, 1999).

In many contexts, however, states are unlikely to undertake significant policy change to comply with an agreement without enforcement. In the strictest sense, an institution has enforcement capabilities when it has the ability to compel its members to comply with a law, rule, or obligation. In practice, institutional enforcement can take many forms. Highly legalized institutions,[4] particularly those with legally-binding obligations and delegated implementation authority, may have independent courts that help identify and punish non-compliance. The European Court of Justice (ECJ), for example, not only has the ability to rule that a domestic law violates European Union law, but also can levy penalties against governments for non-compliance.[5] Bilateral investment treaties, on the other hand, allow transnational arbitration where investors can seek to enforce agreements without involving governments (Elkins, Guzman and Simmons, 2006). Finally, some institutions are able to enforce rules by denying loans or technical assistance, or withdrawing membership benefits (Abbott et al., 2000). For most institutions, however, enforcement is either non-existent or relies on member states to distribute punishment.

While it seems likely that institutions with legally-binding rules and enforcement powers are more effective at generating compliance, isolating the effect of such mechanisms is fraught with empirical difficulties. Most notably, states design agreements with a level of enforcement in mind (Fearon, 1998), and as a result, are likely to select into agreements that require relatively costless policy change (Downs, Rocke and Barsoom, 1996). In such cases, it is hard to know whether the presence of enforcement mechanisms actually constrains state behavior

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[4]Here, I am relying on the definition of legalization put forth in Abbott et al. (2000), who identify three dimensions of legalization: obligation, precision, and delegation.

[5]Indeed, the ECJ can impose financial penalties on states that fail to comply with ECJ rulings (European Commission, 2005).

(Simmons, 2000; Simmons and Hopkins, 2005) or whether the same factors that lead states to commit to an agreement also lead them to comply with it (Martin and Simmons, 2012).

In trying to discern the independent effect of institutions on state behavior, recent scholarship suggests domestic audiences may also play an important role in promoting compliance through monitoring. Dai (2007) argues domestic actors like non-governmental organizations and social movements can serve as compliance monitors, even in states with weak institutions.[6] Simmons (2009) highlights a different pathway, illustrating how signing onto international human rights agreements changes domestic politics inside signatory countries. Specifically, domestic audiences mobilize around enforcing international agreements in a way that influences legislative agendas, alters political coalitions, and even redefines the terms of acceptable state behavior.

Simmons and Dai's arguments highlight two important points for understanding how institutions can enforce agreements. First, monitoring is essential – without information on non-compliance, even the strongest institution will have trouble enforcing its agreement. Second, third parties – whether they be advocacy groups, NGOs, or market actors – can fill an enforcement gap, even when many states may not be interested in true compliance. While Simmons and Dai focus on domestic actors filling both of these functions, an alternative pathway exists whereby institutions themselves serve as monitors and third parties around the globe serve as enforcers. When there is a demand for information about non-compliance and when institutional monitoring is clear and credible, market actors will have incentives to serve as indirect enforcers by punishing non-compliance.

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[6]Dai (2007) identifies two conditions for effective international monitoring: interest alignment between victims of non-compliance and states, and the availability of such victims as low-cost monitors.

2.2 Theory

International institutions differ widely with respect to both legalization and enforcement power, but across many types of institutions, members have been willing to establish monitoring procedures. Decoupled from enforcement, monitoring may be seen as a way to appease states pushing for strong cooperation without overtly threatening those that want to avoid costly policy change. Indeed, states may even choose to delegate monitoring authority to institutional bodies (Nielson and Tierney, 2003) or private actors (Green, 2013). The UN Security Council, for example, has monitoring teams of independent experts that oversee the implementation of various sanctions regimes. These teams publish annual reports detailing to what degree states are implementing sanctions against target countries; there is, however, no type of enforcement against states that violate the sanctions. For this reason, the Council has set up monitoring teams even for regimes with blatant violators.[7]

What is the long-term effect of such monitoring schemes? Under certain conditions, institutional monitoring can provide an alternative pathway for generating compliance. When organizational bodies publish compliance reports or publicly identify non-compliant jurisdictions, such actions increase the amount of information available about state behavior. In particular, institutional monitoring reports can provide unique information about the depth and effectiveness of a state's efforts to address a particular policy issue. If market actors use this new information to make decisions about how to allocate resources to states, they serve to reinforce the institutional rules and push states toward compliance.[8]

International institutions are most effective at transmitting information about non-compliance when they are credible, i.e. able to send a reliable, believable signal about a country's be-

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[7]For example, in 2009 the Security Council created a Panel of Experts to monitor the implementation of sanctions against North Korea (UNSCR 1874 (2009)), despite the fact that China, a permanent member of the Security Council, is generally considered to be the largest violator of the sanction regime.

[8]In her analysis of international monetary commitments, Simmons (2000) highlights the role of markets, arguing that states sign on to Article VIII to make a credible commitment to market actors. As a result, states that sign on to Article VIII have higher market incentives to comply with their obligations.

havior.[9] The most important determinant of credibility is the degree of independence of institutional monitoring. Goldstein et al. (2000) assert that delegation of monitoring to a third party is an aspect of legalization, but more independent monitoring does not always coincide with more legalized regimes. While institutions like the WTO may be legally-binding and also have independent judiciaries, many international regulatory regimes have independent monitoring bodies with no legal authority. Thus independent monitoring can take place in both legalized and extra-legal contexts.

Institutional transparency also affects perceptions of credibility. When institutions formulate clear standards and methodologies for evaluating state behavior, they reduce the existing informational asymmetry between states and institutions. This makes institutional monitoring procedures increasingly meaningful and credible, because they are less likely to reflect bureaucratic or political pressures.

In addition to credibility, institutional monitoring is more likely to generate indirect market enforcement when it sends a clear signal about state behavior. Third-party consumers of monitoring reports, whether they be states, other international organizations, or market actors, are inundated with information on a daily basis. For such information to affect decisions about allocating resources, it must be easy for such observers to interpret; the most effective types of institutional monitoring will send very clear signals about the cooperation behavior of states.[10]

Institutional monitoring reports range in clarity, depending on the length of the report and the inclusion of specific quantitative or qualitative ratings of state behavior. Long reports with no indicators will send the least clear signal about behavior, while short reports with indicators will send significantly stronger signals. Indicators are particularly helpful because

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[9]Note that I am not referring to the institution's ability to make a credible commitment about its interest or willingness to follow through.

[10]This argument is in line with the findings of Brooks, Cunha and Mosley (2014), who argue investors use heuristics like geography and sovereign credit ratings in peer countries to make decisions about risk premiums for sovereign debt.

they allow third parties to compare states with their peers. Since many resource allocation decisions are relative (e.g. an investor deciding whether to buy debt in country A or country B), monitoring reports that facilitate cross-country comparisons will be particularly powerful.

Demand for Information

Institutional monitoring is most likely to generate indirect enforcement when market actors perceive state non-compliance as likely to impact profit margins. Koppell (2010) labels this a "market-based approach" to compliance, because market participants like investors and companies can decide where to invest and deploy capital on the basis of state behavior. Historically, market participants have cared about monitoring reports because company profits can be affected by factors like the risk of expropriation or political collapse. In recent years, there has also been an increase in consumer-driven demand for monitoring, such that companies may be concerned about a country's human rights or environmental record because such factors affect marketability.

Government regulation can also drive demand for information. When governments craft laws requiring private actors to conduct business abroad in a way that takes into account the domestic characteristics of other countries, firms suddenly have a need for additional information on a host of relevant factors. Financial institutions, for example, face much more stringent regulatory requirements today than at any time in history. As a result of 9/11, the US government now requires financial institutions to establish due diligence programs that include specific, risk-based procedures and controls designed to detect and report money laundering activities.[11] Specifically, US-based banks and investment firms must consider geographic risk when deciding whether and how to do business with a particular customer. US government due diligence regulations have created the demand for more detailed information about country policies that might affect calculations of country risk.

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[11]These obligations were first set out in Section 312 of the USA PATRIOT Act and are discussed in brief at: `http://www.fincen.gov/news_room/rp/rulings/html/312factsheet.html`

Demand is also related to what types of actors are interested in institutional monitoring reports. For third parties to serve as indirect enforcers, they must control some amount of resources that can be reallocated on the basis of new information. Multinational banks, investment firms, and corporations are perhaps the most likely actors to play this role; however, depending on the size of a country's economy, even domestic investors buying short-term treasury bills or consumers avoiding a particular product can serve as enforcers. The key insight here is that market actors react to the information contained in a monitoring report by reallocating resources, indirectly punishing non-compliant states.

3   Background on the FATF

3.1   History of the FATF

The FATF is an informal intergovernmental body that was created in 1989 in response to growing concern over money laundering.[12] Founding members included the G-7 countries,[13] the European Commission, and eight other European states.[14] A year after its creation, the FATF issued a set of 40 recommendations on how states should combat the problem of money laundering through legal and regulatory action. Since that time, the Task Force has developed a rigorous methodology for evaluating state compliance and undertaken multiple evaluations of member state policies. It has also increased its membership, and currently includes 34 member jurisdictions and 2 regional organizations.[15] The FATF has also broadened its reach through its associate members – today there are eight FATF-style regional bodies that assess compliance with the Task Force's recommendations in more than 170

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[12]FATF members fund the FATF on a temporary basis with specific goals and projects articulated in its mandate. The most recent mandate is for eight years and was approved in 2012 (FATF-GAFI, 2012).

[13]Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

[14]Australia, Austria, Belgium, Italy, Luxembourg, Netherlands, Spain, and Switzerland.

[15]The 34 "jurisdictions" include 33 member countries and one member jurisdiction (Hong Kong, China).

countries.[16]

In 2001, following the 9/11 terrorist attacks, the FATF expanded its mandate to address the problem of terrorist financing. Building on action by the UN Security Council, the Task Force issued eight special recommendations on how states should combat the financing of terrorism. These recommendations include the ratification and implementation of UN resolutions and treaties on terrorism, the criminalization of terrorist financing, the reporting of suspicious transactions related to terrorism, and the increase of international cooperation on this issue. In 2004, the FATF added a ninth recommendation on detecting the physical cross-border transfer of currency and other similar instruments. Although states are expected to comply with all "40+9" recommendations, in 2009, the FATF identified 16 "key and core" recommendations as its most important priorities.[17] The key/core recommendations include 11 of the 40 anti-money laundering recommendations and 5 of the 9 special recommendations on combating the financing of terrorism.[18]

3.2   The Demand for Information

Why do transnational actors like banks and investment firms care about whether states comply with the FATF recommendations? If anything, the expectation might be that market actors would prefer to do business in countries that do *not* implement the FATF recommendations since the policies are costly to financial institutions. After all, half of the FATF's recommendations apply directly to financial institutions and non-financial businesses, requiring these actors to put in place cumbersome systems to vet customers and report suspicious transactions. In 2012, the US Federal Reserve estimated that the institutions it supervises spend approximately 90,000 hours per year on paperwork related to suspicious activity re-

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[16] A full list of FATF members and the eight regional bodies is available in Appendix A.

[17] Two FATF documents from 2009 include references to the key and core recommendations (FATF-GAFI, 2009b,a). In interviews, some officials have suggested that the core recommendations may have been established even earlier (Skype interviews conducted by author on 7 January 2015 and 27 January 2015).

[18] For more information on the specifics of the recommendations, please see Appendix B.

ports alone (The Federal Reserve, 2012).

Market actors care about AML/CFT risk for several reasons. First, the US government has transposed FATF recommendations into law, so US-based financial institutions are now required to establish customer due diligence procedures. As part of these procedures, financial institutions categorize customers as high, medium, or low risk and treat them differently based on their ratings.[19] Although companies use a variety of metrics to assess risk, geography is often the most important factor. While a number of different factors go into assessing country risk, a key input in this process is a country's AML/CFT vulnerabilities. Indeed, Thomson Reuters' Country Check software – one of the most popular tools for assembling a country risk index – even includes an AML default setting for financial firms or other companies that want to weigh AML risk more heavily (Phone Interview by author of Thomson Reuters official, 29 September 2015). The US government not only expects financial institutions to maintain these risk systems and validate their models, but also follows up by assessing compliance. A Citibank official noted that in today's regulatory environment, it is easy for firms to find themselves suddenly facing an AML lapse (Phone Interview by author, 28 August 2015). And the financial penalties for such an oversight can be significant. In 2012, for example, the US Government fined HSBC 1.256 billion US dollars for "failing to maintain an effective anti-money laundering program and to conduct appropriate due diligence on its foreign correspondent account holders" (US Department of Justice, 2012).

Market actors also care about AML/CFT risk because of potential damage to their companies' reputations. Interviews suggest financial institutions see themselves as having a major responsibility to help detect money laundering and prevent terrorist financing. No firm wants the reputational damage of having been used as a vehicle for criminal activity, or worse, as a channel for financing terrorism (Phone Interview by author of Citibank official, 28

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[19]For more on the FATF's "risk-based approach" and its guidance to the private sector, see `http://www.fatf-gafi.org/documents/riskbasedapproach/?hf=10&b=0&s=desc(fatf_releasedate)`.

August 2015). In fact, damage to reputation is often used as a way to sell risk management systems to financial actors. A representative of Thomson Reuters' World-Check, which is the leading and largest risk-based database, said that if firms were solely concerned with regulatory issues, they'd be unlikely to need expansive risk management tools. But in actuality, financial institutions view the potential financial costs associated with reputational damage and regulatory issues as equally important (Phone Interview by author, 28 September 2015).

Market actors may actually be punished themselves by investors for not staying abreast of AML/CFT risk. Within the financial industry, there are several companies that offer socially-minded research-based indexes and analytics to help investors manage their portfolios. For example, leading research-provider MSCI produces several environmental, social, and governance indexes that rate thousands of companies worldwide on a range of factors, including AML exposure.[20] In an interview, an MSCI official reported that large institutional asset managers and owners care about whether a company has significant assets in a high-risk AML/CFT country because it indicates a higher risk of punitive action by the US Government (Phone Interview by author, 25 September 2015).[21]

3.3 FATF Monitoring

Mutual Evaluation Reports

FATF mutual evaluation reports evaluate to what degree countries are implementing the "40+9" recommendations on combating money laundering and terrorist financing. The FATF began this evaluation process soon after the adoption of the original 40 recommendations on money laundering, and is currently on its fourth round of mutual evaluations.[22]

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[20]According to its website, as of June 2015, MSCI served 97 of the top 100 largest asset managers.

[21]The MSCI official gave the example of an investor deciding whether to buy shares in Bank of America or Standard Chartered. Bnak of America is global but very centered in the US, whereas Standard Chartered is targeted emerging markets. In the official's words, "you can see that difference unfold because Standard Chartered has paid 1 billion in sanctions" (Phone Interview with author, 25 September 2015).

[22]For a detailed discussion of the FATF's early evaluation process, see Nakagawa (2011, 311-316).

For each recommendation, a team of assessors rates a country's level of a compliance as follows:[23]

- **Compliant** - The Recommendation is fully observed with respect to all essential criteria.

- **Largely Compliant** - There are only minor shortcomings, with a large majority of the essential criteria being fully met.

- **Partially Compliant** - The country has taken some substantive action and complies with some of the essential criteria.

- **Non-Compliant** - There are major shortcomings, with a large majority of the essential criteria not being met.

- **Not Applicable** - A requirement or part of a requirement does not apply, due to the structural, legal, or institutional features of a country e.g. a particular type of financial institution does not exist in that country.[24]

The FATF's evaluation process is generally perceived as extremely technocratic.[25] FATF assessments are conducted by a small team of evaluators made up of legal and financial experts drawn from peer countries, FATF Secretariat officials, and often bureaucrats from the International Monetary Fund or the World Bank. The FATF's methodology document, which guides this process, is more than 70 pages long and provides detailed criteria for assessing each recommendation. Evaluators spend weeks in each country meeting with government ministries and assessing laws, and spend months producing final evaluation reports. As a result, mutual evaluation reports tend to be long documents, often more than 200 pages, and contain extensive justifications for each rating.

Evaluated countries have two channels through which they can try to influence the contents of mutual evaluation reports. First, they provide input to evaluators during the evaluation process. Second, they can argue against portions of the draft final report during the

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[23]The rating levels are copied directly from (FATF-GAFI, 2009b), page 6.

[24]This latter category is almost never used.

[25]This statement is informed by interviews of officials from various international organizations and from parts of the US government that work closely with the FATF.

plenary session where the FATF or associated regional body approves the report (Nakagawa, 2011). The final report is adopted by the full membership through consensus.[26]

The structure of the evaluation process and the fact that different countries are evaluated at different times create incentives for states to hold each other accountable. While there may be some room for powerful countries to petition the membership during plenary sessions for better ratings, a review of the mutual evaluation reports suggests that even countries perceived as AML/CFT policy leaders receive non-compliant ratings. In its 2006 evaluation, for example, the United States was rated non-compliant on four recommendations (FATF-GAFI, 2006), while other G-7 members like Japan and Canada were rated non-compliant on 10 and 11 recommendations respectively (FATF-GAFI, 2008b,a).

The Blacklist

Since its inception, the FATF has used two separate blacklisting processes to incentivize policy change in states.[27] In the early 2000s, the FATF used the "Non-Cooperative Countries and Territories" process to identify jurisdictions with money laundering deficiencies and force them to change their laws (Sharman, 2008). This process, however, did not address deficiencies related to combating terrorist financing nor did it encompass significant changes made to the FATF's recommendations in 2004. Following a short hiatus, the FATF established a new blacklisting process under the auspices of its International Cooperation Review Group. In February 2010, for the first time in almost a decade, the FATF issued a new blacklist of high-risk states.

Three times a year, the FATF publishes updates to its blacklist.[28] Blacklisted states are placed at one of four different levels of listing. Most states are only listed at the lowest

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[26]According to an interview, approval from the evaluated country is not necessary, and thus it is often "consensus minus one." Skype interview by author, 7 January 2015.

[27]I use the term "blacklist" to describe the FATF's process of publicly identifying non-compliant jurisdictions. While the FATF itself does not refer to this process as "blacklisting," media outlets and government officials in listed countries generally use this terminology.

[28]The FATF meets in February, June, and October of every year. At each plenary session, the FATF issues new statements on high-risk jurisdictions.

Variable	Blacklisted Countries	Not Listed Countries
GDP Per Capita	4599.7	14300.6
	(9733.7)	(17564.7)
Polity	3.2	5.8
	(5.9)	(5.8)
FDI (in billions)	2.5	13.0
	(3.9)	(42.2)
Financial Risk	9.8	11.5
	(5.2)	(4.5)
Economic Risk	16.3	14.1
	(6.4)	(5.1)

Table 1: *2013 Descriptive Statistics* - The table reports the mean and standard deviation (in parenthesis) for countries that the FATF blacklisted at some point during its current process and states that have never been listed. Financial risk and economic risk are drawn from the Political Risk Group's International Country Risk Guide dataset. Financial risk measures a country's ability to finance its official, commercial, and trade debt obligations, while economic risk is based on an assessment of a country's current economic strengths and weaknesses. Both financial risk and economic risk are on a scale of 0 (lowest risk) to 50 (highest risk).

level, which identifies countries that have strategic deficiencies but have made a "written high-level commitment" to improve AML/CFT laws.[29] Subsequent levels include a warning list that identifies jurisdictions not making enough progress and a enhanced due diligence list that identifies countries failing to make progress or failing to commit to an FATF action plan. The highest level is the FATF's counter-measures list, which has only ever included two states: Iran and North Korea.

Table 1 provides descriptive statistics, comparing countries that have been blacklisted under the current process with countries that have never been listed. Not surprisingly, blacklisted countries are, on average, poorer and less democratic. They also have lower levels of foreign direct investment (FDI). Interestingly, as of 2013, they do not differ significantly from non-listed countries in terms of financial or economic risk.

Is the FATF's blacklisting process coercive in nature? Certainly, one could claim that

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[29]This list is issued as part of the FATF's "Improving Global AML/CFT Compliance" statement.

calling on states to undertake counter-measures against Iran and North Korea is fairly close to enforcement. But this ignores several key facts. First and most importantly, the FATF is not a treaty-based organization so its declarations are not legally-binding on states. Moreover, even if it were legally binding, the language of the counter-measures list does not require states to undertake counter-measures but rather "calls upon" them to do so. But even if we view the FATF as having coercive abilities toward North Korea and Iran, the FATF has taken a very different approach when dealing with other countries. The FATF has never evaluated AML/CFT policies in North Korea and Iran, yet they have been blacklisted since the inception of the list. And even when other states have had long-term strategic deficiencies, the FATF has never moved these countries up to the counter-measures list.[30]

Despite its lack of enforcement power, the FATF blacklist has been remarkably successful at generating policy change in states. Since 2010, the FATF has listed 56 countries, 38 of which have been removed from FATF monitoring following significant improvements in their laws. For countries to be removed from the blacklist, they must adopt and implement mechanisms to address specific deficiencies identified by the FATF (FATF-GAFI, 2009a). Additionally, a team of FATF evaluators often travels to the listed jurisdiction to verify that a full reform and implementation process is underway prior to removing the state from the list.[31]

Table 2 shows all countries that have been listed at some point in time, along with the year of listing and where relevant, the year of de-listing. As can be seen in the table, the FATF blacklisted the most countries in 2010, but it continues to add countries each year.

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[30]Ecuador, for example, has been on the FATF blacklist since February 2010.

[31]See, for example, the the FATF's statement on Yemen, contained in FATF-GAFI (2014).

Country	Blacklisted	Graduated
Afghanistan	2012	–
Albania	2012	2015
Algeria	2011	–
Angola	2010	–
Antigua and Barbuda	2010	2014
Argentina	2011	2014
Azerbaijan	2010	2010
Bangladesh	2010	2014
Bolivia	2010	2013
Bosnia-Herzegovina	2015	–
Brunei Darussalam	2011	2013
Cambodia	2011	2015
Cuba	2011	2014
DPRK	2007	–
Ecuador	2010	–
Ethiopia	2010	2014
Ghana	2010	2013
Greece	2010	2011
Guyana	2014	–
Honduras	2010	2012
Indonesia	2010	2015
Iran	2007	–
Iraq	2013	–
Kenya	2010	2014
Kuwait	2012	2015
Kyrgyzstan	2011	2014
Laos	2013	–
Mongolia	2011	2014
Morocco	2010	2013
Myanmar	2010	–
Namibia	2011	2015
Nepal	2010	2014
Nicaragua	2011	2015
Nigeria	2010	2013
Pakistan	2010	2015
Panama	2014	–
Papua New Guinea	2014	–
Paraguay	2010	2012
Philippines	2010	2013
Qatar	2010	2010
Sao Tome and Principe	2010	2013
Sri Lanka	2010	2013
Sudan	2010	–
Syria	2010	–
Tajikistan	2011	2014
Tanzania	2010	2014
Thailand	2010	2013
Trindad and Tobago	2010	2012
Turkey	2010	2014
Turkmenistan	2010	2012
Uganda	2014	–
Ukraine	2010	2011
Venezuela	2010	2013
Vietnam	2010	2014
Yemen	2010	–
Zimbabwe	2011	2015
Total	56	39

Table 2: *Countries Blacklisted by the FATF (2010-2015)* - The FATF has blacklisted 54 since countries since 2010, when it revitalized its blacklisting process (Iran and North Korea were listed under the old process and kept on the list). The table shows the blacklisted countries, the year of blacklisting, and the year of graduation (where relevant). Countries that graduate are removed from FATF monitoring due to significant policy change (with the exception of Sao Tome and Principe, which the FATF decided was a low threat and no longer needed monitoring).

4 Hypothesis

Because the FATF issues recommendations about how states should increase regulations and reduce vulnerabilities in their financial systems, global and domestic financial actors are likely to be interested in the results of FATF monitoring reports and in FATF blacklisting announcements. As discussed earlier, banks and investment firms use complex models to assess customer risk, and a key input is geography. Maintaining these models and keeping them up-to-date is a cumbersome process. According to one Citibank official, FATF blacklisting provides useful information to financial firms "purely because it's a quantitative measure that you can put in a risk model" (Phone Interview by author, 28 August 2015). Similarly, a Credit Agricole official reported that when they assess customer risk, they rank countries by AML risk, and a key input into this ranking is whether a country is on the FATF blacklist (Phone Interview by author, 25 September 2015).

News reports also suggest that government officials in listed states view being publicly identified through the FATF blacklisting process as likely to impose costs on the banking industry and other domestic financial actors. When the FATF listed Antigua and Barbuda in February 2010, for example, the parliamentary opposition leader suggested this would affect not only the financial industry but also businesses, and even transactions by ordinary people (Caribarena news, 2010). In Thailand, which was also listed by the FATF in 2010, the chief executive of the CIMB Thai Bank argued that the government should comply with the FATF by amending the Anti-Money Laundering and the Anti-Terrorism Act to improve the "image" of the country's financial system and prevent major damage to financial transactions (Fernquest, 2012).

Interviews with officials from international organizations involved in improving state policies on AML/CFT corroborate this view. According to a UN official, the FATF review process is effective because it has consequences. If a country is blacklisted by the Task Force,

the country's banks immediately have problems, so the government comes under pressure from the financial system to change its policies. As the UN official put it, "countries are used to being named and shamed, but when something hurts the pockets of bankers, they [government officials] are usually more sensitive to requests" (In-person interview conducted by author, 8 May 2014).

Investors might react to FATF blacklisting through a variety of different financial channels, depending on the degree to which a country is integrated into the global financial system. Financial risk ratings provide a way to proxy this aggregate affect, because banks, investment firms, and companies all use such measures when they decide how to allocate resources in foreign countries. This suggests the following hypothesis:

- *Hypothesis: FATF blacklisting should lead to an increase in financial risk ratings.*

5   Data and Measurement

My analysis examines how FATF blacklisting announcements affect country financial risk ratings for the period of 2010 to 2015. I begin the analysis in 2010 because that is start of the current FATF blacklisting process. Data on the FATF blacklist is drawn from FATF blacklisting announcements (published online in February, June, and October every year). I also rely on the FATF's third round of mutual evaluation reports, which assess compliance with the FATF "40+9" recommendations, focusing specifically on FATF evaluations of country compliance with the 16 key and core recommendations, which the FATF has identified as its most important priorities. In creating my data set, I hand-coded FATF ratings on these 16 key and core recommendations. I follow the FATF standard in considering ratings of partially compliant or non-compliant to be "failing."

I test my theory through two different empirical specifications. I first run an ordinary least squares (OLS) regression model with country and year-fixed effects on financial risk

data from 2010 to 2015. My data set includes complete data for 110 countries, 36 of which were on the FATF blacklist at some point during this time frame. Because the FATF updates its blacklist three times per year, the unit of observation is country-month, but I restrict my analysis to observations for the months that the FATF updates the blacklist (February, June, and October). As a result, there are only three observations for each country in a given year for a total of 1515 observations. I lag all explanatory variables by one year to account for the possibility of simultaneity.

For a smaller subset of countries, I use an instrumental variable analysis that takes advantage of a natural experiment wherein countries that receive 10 or more failing recommendations are automatically eligible for blacklisting. This analysis adopts an approach similar to a regression discontinuity design, comparing countries just above and just below the 10-failing-recommendation threshold. I restrict the sample to two windows: countries that received between 9 and 10 failing recommendations, and countries that received between 8 and 11 failing recommendations. The 9-to-10 window data set includes 15 countries (3 listed) and 176 observations, while the 8-to-11 window data set includes 21 countries (4 listed) and a total of 269 observations. This approach and its requisite assumptions are discussed in greater detail in Section 5.4.

5.1 Dependent Variable: Financial Risk Ratings

Given that my theory suggests the FATF blacklist affects states through the financial industry, I evaluate the effect of the blacklist by looking at financial variables. Existing IR scholarship has documented how investors consider a government's reputation when making financial decisions about where to invest. Tomz (2007) suggests investors form beliefs about a state's reputation by observing a state's behavior, specifically its record of debt repayment. Investors then respond to this reputation by charging more for risky investments (perhaps by raising interest rates), controlling risk by designing restrictive lending contracts, or re-

fusing to lend to countries. Gray (2013) suggests it it not just a country's financial record, but also other factors like its membership in international institutions, which give investors information about a country's willingness to honor its debt obligations.

Both of these arguments highlight how information about state behavior feeds into investor appraisals of country risk. In this paper, I suggest that institutional monitoring can be a vital source of information for investors interested in assessing the financial prospects of a country. Ideally, I would follow Tomz and Gray in examining financial reputation by looking at sovereign debt yields, with the expectation that blacklisting would lead to higher risk and concomitant higher yields. Unfortunately, however, more than fifty percent of the countries that end up blacklisted by the FATF do not sell long-term bonds. For this reason, focusing exclusively on bond yields would have limited external validity for explaining why blacklisted states that do not sell bonds are nonetheless incentivized to change their policies.

Depending on the nature of a country's financial system and its integration into the world economy, market actors might react to blacklisting announcements in different ways. As a proxy for this aggregate effect, I examine a key input into the decision-making process: economic risk data. Specifically, I use the monthly Financial Risk Rating produced as part of the PRS Group's International Country Risk Guide.[32] This variable is a proxy for a country's ability to finance its official, commercial, and trade debt obligations.[33] Risk ratings range from 0 (lowest risk) to 50 (highest risk), although most countries do not fall above 35.[34] In 2014, the average level of financial risk was 11.6, with a standard deviation of 5.0. Most

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[32]The PRS Group's International Country Risk Guide has provided political, financial, and country risk forecasts to investors, businesses, private equity groups, and multilateral institutions since 1980. Companies in the financial industry use PRS products for both portfolio and risk management. The ratings are also used by development banks and lending agencies.

[33]To assemble the financial risk rating, the PRS Group assesses risk for the following economic components: foreign debt as a percentage of GDP, foreign debt service as a percentage of exports of goods and services (XGS), current account as a percentage of XGS, net liquidity as months of import cover, and exchange rate stability.

[34]This is an inversion of the normal PRS financial risk scale, where 0 = highest risk and 50 = lowest risk. For more on the PRS Group's methodology, see The PRS Group (2011).

Financial Risk:
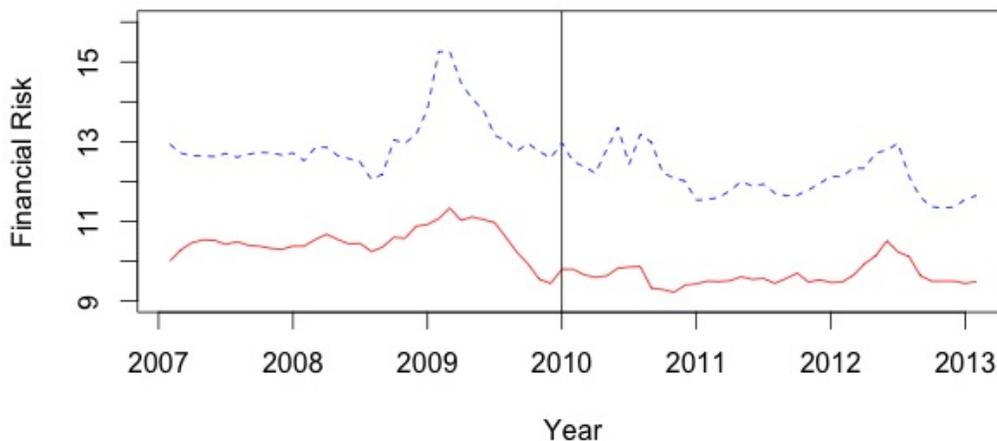**Blacklisted vs. Non-Listed Countries**

Figure 1: The figure compares the average level of financial risk in countries that the FATF blacklisted in 2010 (red solid line) with average financial risk in countries that have never been listed (blue dotted line).

countries have ratings between 5 and 15, with the lowest risk rating in 2014 belonging to Saudi Arabia and the highest rating belonging to Estonia.

Figure 1 shows the variation of financial risk ratings over time, comparing the average level of financial risk in countries blacklisted in 2010 with the average level of financial risk in countries that are never listed during the same period. The FATF considers the size and integration of a country's financial sector when deciding whether to blacklist countries under the premise that countries that are more integrated into the global economy pose a greater money laundering and terrorist financing risk. This trend is reflected in the data – across time, blacklisted countries have, on average, lower levels of financial risk than non-listed countries. In 2014, average financial risk in blacklisted countries was 11.1, while average financial risk in non-listed countries was 12.2 (p-value: <0.001).

5.2 Independent Variable: Blacklisting

If institutional monitoring produces indirect market enforcement, then blacklisting should generate financial consequences for non-compliant states. As such, the independent variable of interest is whether, at a given point in time, a country is on the FATF blacklist. This variable could be operationalized either dichotomously, where 1 indicates a country is listed and 0 indicates otherwise, or separately, based on the level of blacklisting. I choose the former approach for two reasons. First, analyzing the lists separately significantly reduces sample size, which is already a concern given the small pool of countries and the limited time frame. Second, with the exception of the counter-measures list, it is not clear that different levels of blacklisting should have different consequences for states. Almost all states start out on the lowest list; the FATF only moves a country to a higher list if its government fails to make progress in addressing AML/CFT deficiencies. Indeed, states have undertaken significant policy change and been removed from all three lower levels of the list.

5.3 Control Variables

My primary empirical analysis includes control variables likely to influence both the probability that a country is blacklisted and its financial risk rating. Conveniently, the FATF has articulated very clear guidelines for blacklisting eligibility. A country is eligible for blacklisting if it:

- (a) receives 10 or more failing ratings on the 16 key and core recommendations;
- (b) fails to participate in the FATF or a regional affiliate and its concomitant evaluation process; or,
- (c) is nominated by the FATF or a regional affiliate for blacklisting consideration (FATF-GAFI, 2009a).

Once a country is eligible, the FATF makes decisions about whether to blacklist on the basis of several factors, including the size and integration of the country's financial sector, the risk

of money laundering and terrorist financing, and a country's failure to criminalize money laundering or terrorist financing.[35]

To account for the FATF's selection into blacklisting, I include several FATF-specific controls, including FATF MEMBER, which indicates whether a country is an FATF member in a given year, and FSRB MEMBER, which indicates whether a country is a member of an FATF-style regional body in a given year. Because a country's existing AML/CFT infrastructure might affect both the probability of blacklisting and its financial risk rating, I also include NUMBER OF FAILING RECOMMENDATIONS. I created this variable based on information contained in the mutual evaluation reports; it reflects the total number of non-compliant and partially compliant ratings on the 16 key/core recommendations. In general, the FATF and its regional bodies only evaluate a countries once per cycle, so for most countries, the number of failing recommendations does not change across the data set.[36] Finally, the FATF listing guidelines state that countries that do not undergo a mutual evaluation are eligible for blacklisting, so I include NO EVALUATION to account for this trend.

There are several other control variables that could affect both a country's probability of being blacklisted and its financial risk level. According to FATF guidelines, the size and integration of a country's financial sector–and in particular, the percentage and total assets held in non-resident accounts–are key determinants of whether the FATF decides to blacklist a country(FATF-GAFI, 2009a). As a proxy for these considerations, I include NET FINANCIAL ACCOUNT, which is drawn from the IMF Balance of Payment Statistics and shows the net acquisition and disposal of financial assets and liabilities. Specifically, this variable encompasses net inflows and outflows related to direct investment, portfolio

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[35]Additional factors include not adequately responding to requests for international cooperation, the extent tow hicha country has sought and implemented technical assistance, the degree to which the country has demonstrated a willigness to address its AML/CFT deficiencies, and whether the country is involved in a follow up process with the FATF or a regional affiliate(FATF-GAFI, 2009a).

[36]Countries belonging to the Council of Europe's MONEYVAL are a notable exception to this trend.

investment, other investment, and reserve assets.[37] Because balance of payments is highly skewed and can be either positive or negative, I transform the variable – for all observations, I subtract the minimum value in the dataset (-32.8 billion), add 1, and then take the log of this number.

I also include GDP and GDP PER CAPITA, as the size of a country's economy as well as its income level may affect the FATF's decision to blacklist and its ability to repay debt. The FATF considers the size of a country's financial sector when making decisions about blacklisting; GDP is likely to be correlated with this factor and is thus a stand-in for financial size. GDP per capita, on the other hand, is intended to proxy for a country's capacity, under the theory that more capable countries will either undertake policy change or negotiate with FATF to avoid being blacklisted, and may also be better able to repay their debt obligations. I transform both variables by adding 1 and take the log.

Finally, I include POLITY IV to control for the extent of democracy in a country. Existing scholarship suggests international financial actors view democracies as more credit worthy and less risky investment prospects (Schultz and Weingast, 2003; Beaulieu, Cox and Saiegh, 2012); these arguments would suggest that democracy should be correlated with lower levels of financial risk. On the other hand, democracy could affect the selection process into blacklisting, in that democratic countries may have a more difficult time changing their laws to comply with FATF recommendations due to institutional constraints.

5.4   Accounting for Selection Effects

The first empirical specification attempts to address selection issues by controlling for factors likely to affect the probability of being blacklisted and a country's financial risk rating. The FATF, however, also considers several factors that are difficult to measure, such as a country's willingness to seek and implement technical assistance and its willingness to reform

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[37]For more on this measure, please see `https://www.imf.org/external/np/sta/bop/BOPman.pdf`.

its AML/CFT deficiencies. To address concerns about possible omitted variable bias, I also conduct a second analysis that takes advantage of a natural experiment introduced by the FATF's bureaucratic procedures. Prior to the establishment of the blacklisting process, the FATF and its regional affiliates evaluated compliance in 95 countries. Many of these countries found themselves suddenly eligible for blacklisting on the basis of the 10-failing-recommendation automatic referral process. I use whether a country ended up just above the 10-failing-recommendation threshold as an instrument that increases the probability of blacklisting (compared to countries just below the threshold).[38] As can be seen in Figure 2, countries that fail on ten or more key and core recommendations are significantly more likely to be blacklisted than those that fall below the threshold.[39]

To calculate the effect of blacklisting on financial risk, I use a two-stage least squares (2SLS) approach. In the first stage, I estimate the following equation:

$$\widehat{\text{blacklisting}}_{it} = \alpha + \beta_1 \text{encourage}_i + \beta' \theta_{it} + \epsilon_1,$$

where **encourage** is a dichotomous variable equal to 1 if a country was above the cutoff and 0 otherwise, and θ_i is a vector of country-specific variables, including the number of failing key/core recommendations and a dichotomous indicator of whether a country is a FATF member in a given month. **Blacklisting** is a dichotomous variable equal to 1 if a country is blacklisted at a given point in time and 0 otherwise, and ϵ_1 is the error term.

Using the fitted values from this first-stage regression, I estimate the following equation for the second-stage:

$$\widehat{\text{financial risk}}_{it} = \alpha + \beta_1 \text{blacklisting.hat}_{it} + \beta' \theta_{it} + \epsilon_2,$$

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[38]Such an approach is similar to identifying the causal effect of treatment in a randomized experiment with noncompliance (Angrist, Imbens and Rubin, 2012).

[39]Indeed, only 3 of the 56 listed countries received ratings of non-compliant or partially compliant on less than 10 key and core recommendations. These 3 countries – Albania, Paraguay, and Turkmenistan – all have since graduated from the list.

**Compliance Comparison:
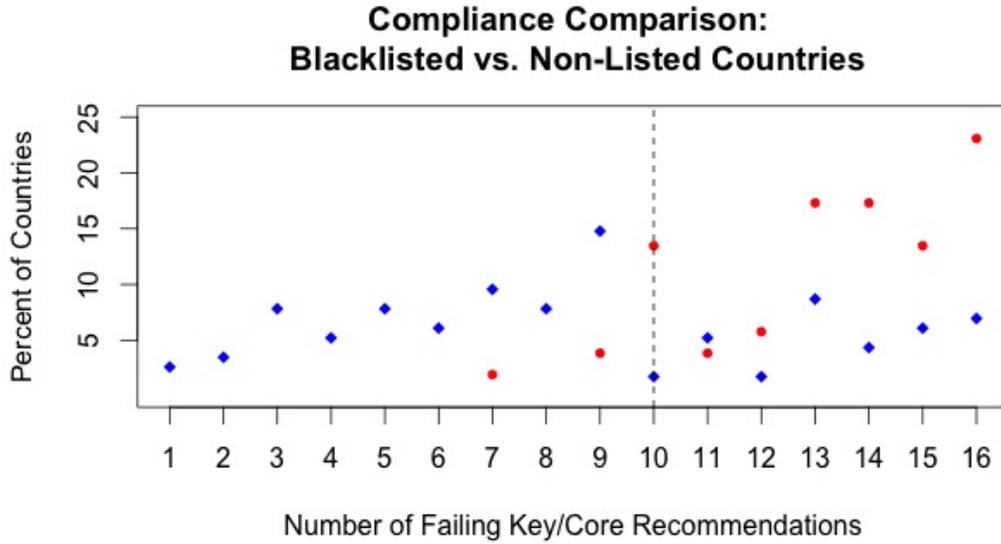Blacklisted vs. Non-Listed Countries**

Figure 2: The figure shows the percent of blacklisted countries (red circles) and non-listed countries (blue diamonds) by the total number of non-compliant or partially compliant ratings (key and core recommendations only). Percents calculated as the number of listed (unlisted) countries at each aggregate rating level divided by the total number of *evaluated* listed (unlisted) countries. The figure highlights how the majority of blacklisted countries fall at or above the 10-failing-recommendation threshold.

where **blacklisting.hat** is the fitted value from the first-stage regression, θ_i is the same vector of country-specific variables, **financial risk** is the financial risk rating for countries following each blacklisting announcement, and ϵ_2 is a modified error term.[40]

As with all empirical approaches, using an instrumental variable design requires making certain assumptions. The first necessary assumption is monotonicity, meaning that the instrument affects all actors in the same way. In the context of the FATF, monotonicity requires us to assume that falling above the 10-failing-recommendation threshold will always either increase a country's probability of blacklisting or have no effect. In other words, it should never be the case that because a country fails on 10 recommendations, they are less likely to be blacklisted than they would at a smaller number of failing recommendations.

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[40]Standard errors are clustered by country.

Given the FATF's bureaucratic nature and the fact that its methodology document clearly specifies this 10 failing recommendation threshold, it seems highly unlikely that monotonicity is violated.

The second key assumption for an instrumental variable approach is the exclusion restriction, which says that the instrument affects the outcome only through the treatment. For this study, the exclusion restriction requires that falling above the 10-failing-recommendation threshold will only affect financial risk through the blacklisting. Put another way, being just above or below the threshold should have no direct effect on a country's ability to service its official, commercial, and trade debt obligations.

How might the exclusion restriction be violated? Once possible way would be if states were able to sort themselves around the threshold. After the FATF created the blacklist, states became aware of the 10-failing-recommendation threshold and the possible consequences of blacklisting. As a result, states with adequate resources and capacity might have worked hard to fall below this cutoff. If this occurred, a country's resources and capacity might affect both the number of failing recommendations and a country's ability to service its official, commercial, and trade debt obligations (thus violating the exclusion restriction). Luckily, the FATF completed the majority of its evaluations prior to creating the blacklisting process, and so my data is drawn exclusively from mutual evaluation reports adopted <u>prior</u> to 2009, when the FATF first began to discuss the criteria for the blacklisting process.[41] The lack of consequences pre-2010, and the fact that mutual evaluation reports do not provide any aggregate score or information on the number of failing key/core recommendations, make it unlikely that sorting would have occurred during this earlier period.

Across this wider data set, there are likely to be significant differences between countries that affect whether they fall below or above the 10-failing-recommendation threshold, and these differences could violate the exclusion restriction. For this reason, I focus my anal-

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[41]The FATF circulated draft blacklisting criteria in May 2009 and adopted them in October 2009.

ysis exclusively on countries right around the threshold, examining first those that fail on either 9 or 10 recommendations, and then expanding my window to 8 to 11 failing recommendations.[42] Since these numbers reflect many different combinations of failing key/core recommendations and only 20 percent of the total (49) recommendations, it seems unlikely that the exclusion restriction is violated. Given the heavily bureaucratic nature of the evaluation process, it is plausible that ending up with 9 rather than 10 failing recommendation is as-if random.

If there is no sorting taking place around the threshold, then we should also not observe significant differences in covariates prior to the imposition of the blacklisting procedure. T-tests of key covariates from 2008 support the comparability of countries just below and just above the cutoff.[43] Importantly, I do not find any evidence of significant differences in financial risk ratings between countries above and below the threshold in this period prior to blacklisting.

6 Results

The results provide strong support for the relationship between FATF blacklisting and financial risk ratings. In both the cross-sectional analysis and the instrumental variable analysis, the effect of blacklisting on financial risk ratings is positive and statistically significant.

Table 3 shows the results of a cross-sectional OLS regression with country and year-fixed effects. Model 1 estimates the effect of blacklisting on financial risk, controlling only for those factors most likely to reflect a country's overall approach to the problems of money laundering and terrorist financing. Model 2 incorporates a country's financial account, which is explicitly used by the FATF as a relevant criteria for determining blacklisting. Model 3

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[42]Appendix C provides a list of countries that qualify as just above or just below the threshold, based on the results of their pre-2009 mutual evaluation report.

[43]The results of this analysis are available in Appendix D.

	Dependent Variable: Financial Risk		
	(1)	(2)	(3)
Blacklisting	0.520**	0.526**	0.451*
	(0.242)	(0.242)	(0.243)
Number of Failing Recommendations	−0.073	−0.073	−0.136*
	(0.077)	(0.077)	(0.078)
No Evaluation	−0.899	−0.911	−1.619
	(0.995)	(0.995)	(1.008)
FATF Member	3.210**	3.211**	2.777**
	(1.343)	(1.343)	(1.341)
FSRB Member	−0.874	−0.871	−0.682
	(0.662)	(0.662)	(0.662)
Financial Account (log)		−0.080	−0.082
		(0.053)	(0.052)
Polity IV			0.185**
			(0.077)
GDP (log)			−3.467
			(2.686)
GDP per capita (log)			8.618***
			(2.934)
Observations	1,515	1,515	1,515
R^2	0.974	0.974	0.974
Adjusted R^2	0.972	0.972	0.972
Residual Std. Error	2.068 (df = 1396)	2.067 (df = 1395)	2.054 (df = 1392)
F Statistic	435.087*** (df = 119; 1396)	431.895*** (df = 120; 1395)	426.741*** (df = 123; 1392)

Note: *p<0.1; **p<0.05; ***p<0.01

Table 3: *The Effect of Blacklisting on Financial Risk - Cross-Sectional Analysis*: All models show the estimates of an OLS regression with country and year-fixed effects. All independent variables are lagged by one year.

adds additional controls for level of democracy and economic power.

The instrumental variable analysis also supports the theory, estimating a larger effect of blacklisting on financial risk across both windows. Table 4 shows the results of a two-stage least squares regression with year-fixed effects. Due to the small number of observations, I only include controls for whether a country is a FATF member and the number of failing recommendations. Model 1 estimates the effect of blacklisting for the 9-to-10 window and Model 2 estimates the effect for the 8-to-11 window.[44]

[44]The IV models do not include clustered standard errors. When I cluster standard errors at the country

	Dependent Variable: Financial Risk	
	(1)	(2)
Blacklisting	4.465*	6.127**
	(2.367)	(2.824)
FATF Member	−2.827***	−5.499***
	(0.867)	(0.972)
Number of Failing Recommendations		0.446*
		(0.266)
Observations	176	336
F-Test on First Stage	37.370	42.820
Wu-Hausman	4.786	8.823
Note:	*p<0.1; **p<0.05; ***p<0.01	

Table 4: *The Effect of Blacklisting on Financial Risk - 2SLS*: All models show the estimates of a two-stage least squares regression where receiving an FATF rating of failing on 10 or more key/core recommendations is used as an instrument for blacklisting. Regressions include year-fixed effects.

The larger coefficients estimated by the instrumental variable analysis suggests the cross-sectional analysis may not fully account for the selection process into blacklisting. In particular, the FATF considers the size and integration of a country's financial sector into the world economy, and the actual money laundering and financing terrorism risk emanating from a country. These factors are likely to be correlated with a country's ability to finance its debt obligations – countries with deficient policies that are more integrated into the global financial system should be more likely to be blacklisted and also have lower levels of financial risk. Indeed, this trend is apparent from the descriptive data – as Figure 1 shows, blacklisted countries have consistently lower levels of financial risk on average across time. As a result, the cross-sectional analysis is likely to underestimate the true effect of blacklisting on financial risk.

level, the coefficients remain unchanged but are no longer significant due to a lack of power.

7   Robustness

7.1   Bond and Treasury Bill Yields

Although financial risk ratings tell us something about the overall investment climate in a particular country, it is unclear exactly how investors will respond to this information. If financial risk ratings affect investor strategy, we would expect to see blacklisting also lead to an increase in bond yields, as investors charge an additional premium for riskier debt. I examine this hypothesis by looking at the yields on long-term and short-term government debt. As discussed earlier, bond data is only available for 50 countries, 9 of which were blacklisted by the FATF, while treasury bill information is available for 69 countries, 24 of which were blacklisted. Due the limited sample, this analysis is intended as a robustness probe rather than a primary test of the theory.

Table 5 shows the estimated effect of blacklisting on bond and treasury bill yields. In line with the theory, investors consider blacklisted countries to be riskier investment prospects and thus charge a premium for debt from these countries. Models 1 and 2 show the effect of blacklisting on bond yields, indicating that blacklisting leads to a roughly 1.5 percent increase in bond yield. Models 3 and 4 show the effect of blacklisting on treasury bill yields. For this type of short-term debt, the effect is smaller but still positive and statistically significant.

7.2   IV Analysis: Placebo Test

If the instrumental variable analysis is really capturing the effect of blacklisting rather than a separate omitted variable, the instrument (falling above the 10-failing recommendation threshold) should have no effect on financial risk in the period *prior* to the establishment of the blacklisting procedure. To probe the validity of this approach, I conduct a placebo test using data from 2008 and 2009 for the same set of countries evaluated in the earlier analysis. The results of this analysis are available in the Appendix and reveal no preexisting

	Dependent variable:			
	Bond Yields		Treasury Bill Yields	
	(1)	(2)	(3)	(4)
Blacklisting	1.655***	1.458***	0.956**	0.674*
	(0.376)	(0.371)	(0.379)	(0.379)
Number of Failing Recommendations	−0.130	−0.152	−0.115	−0.168
	(0.096)	(0.094)	(0.117)	(0.115)
No Evaluation	−0.341	−0.330	0.177	−0.182
	(1.033)	(1.010)	(1.613)	(1.581)
FATF Member	−1.647	−39.499***	0.361	−51.259***
	(1.360)	(9.597)	(1.644)	(11.350)
FSRB Member	6.385***	−356.262***	2.355	−458.218***
	(1.538)	(74.235)	(1.827)	(81.499)
Financial Account (log)		0.054		0.023
		(0.038)		(0.060)
Polity IV		−0.012		−0.094
		(0.135)		(0.154)
GDP (log)		29.194***		34.959***
		(5.375)		(5.785)
GDP per capita (log)		−33.802***		−37.055***
		(5.876)		(6.226)
Observations	628	628	854	854
R^2	0.951	0.954	0.905	0.909
Adjusted R^2	0.946	0.949	0.895	0.900
Residual Std. Error	1.522 (df = 571)	1.482 (df = 567)	2.390 (df = 778)	2.339 (df = 774)
F Statistic	193.337*** (df = 57; 571)	191.026*** (df = 61; 567)	97.056*** (df = 76; 778)	96.748*** (df = 80; 774)

Note: <div align="right">*p<0.1; **p<0.05; ***p<0.01</div>

Table 5: *The Effect of Blacklisting on Yields*: All models show the estimates of an OLS regression with country and year-fixed effects. Models 1 and 2 estimate the effect of blacklisting on bond yields, while models 3 and 4 estimate the effect of blacklisting on treasury bill yields. All independent variables are lagged by one year.

differences in financial risk.

8 Conclusion

States increasingly rely on international institutions that are not legally binding to formulate rules for the world. Under existing understandings of institutional compliance, this trend is somewhat puzzling: why would states expend resources on making deep rules when they cannot be enforced? This paper argues that the structure of institutional monitoring procedures can generate paths to enforcement. Institutional monitoring bodies often have unique access to governments and bureaucracies. Through intense evaluation processes, evaluators are able to assess whether governments are implementing prescribed institutional policies

and to disseminate this information to interested third parties. When market actors use this information to make decisions about resource reallocation, they act as indirect enforcers for the institution, creating new incentives for states to comply with international rules. For this reason, the increase of informal regulatory institutions may be "good news" for international cooperation – more precise rules and more technocratic monitoring may lead to higher levels of enforcement and perhaps even increased global compliance.[45]

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[45]The use of the term "good news" here is a play on Downs, Rocke, and Barsoom (1996): "Is the good news about compliance good news about cooperation?"

Appendix A   FATF Members and Associate Members

Members	Associate Members: FATF-Style Regional Bodies
Argentina	Asia/Pacific Group on Money Laundering
Australia	Caribbean Financial Action Task Force
Austria	MONEYVAL (Council of Europe)
Belgium	Eurasian Group
Canada	Eastern and Southern Africa Anti-Money Laundering Group
China	Financial Action Task Force of Latin America
Denmark	Inter Governmental Action Group against Money Laundering in West Africa
European Commission	Middle East and North Africa Financial Action Task Force
Finland	
France	
Germany	
Greece	
Gulf Cooperation Council	
Hong Kong, China	
Iceland	
India	
Ireland	
Italy	
Japan	
Korea	
Luxembourg	
Mexico	
Netherlands	
New Zealand	
Norway	
Portugal	
Russia	
Singapore	
South Africa	
Spain	
Sweden	
Switzerland	
Turkey	
United Kingdom	
United States	

Table A1: The table shows FATF members and associate members. Italicized members are regional organizations. Most member states belonging to FATF-style regional bodies are not FATF members.

Appendix B FATF Key and Core Recommendations

The FATF has identified 16 of its "40+9" recommendations on combating money laundering and terrorist financing as being the highest priority recommendations for states. In an interview, an FSRB official described the core recommendations as the "building blocks of the AML/CFT regime, without which anything else would be pointless," while the key recommendations are "extremely important, but to a lesser extent" (Skype interview by author, 27 January 2015). The general topics covered by these 16 key and core recommendations are given below.

Core Recommendations

- Criminalization of money laundering and terrorist financing (Recommendation 1, Special Recommendation II)

- Customer identification/record-keeping requirements (Recommendations 5 and 10)

- Suspicious transaction reports reporting (Recommendation 13, Special Recommendation IV)

Key Recommendations

- International cooperation and mutual legal assistance (Recommendations 35, 36, 40, Special Recommendations I and V)

- Freezing and confiscation (Recommendation 3, Special Recommendation III)

- Financial secrecy (Recommendation 4)

- Adequate regulation and supervision (Recommendation 23)

- Functional financial intelligence unit (Recommendation 26)

Appendix C   List of Threshold Countries

8 NC/PCs	9 NC/PCs	10 NC/PCs	11 NC/PCs
Albania	Andorra	Bahrain	**Antigua and Barbuda**
Bahamas	Barbados	**Bolivia**	Croatia
Belarus	China	**Kyrgyzstan**	Gambia
Czech Republic	Malawi	Monaco	Georgia
Lithuania	Mauritius	Slovak Republic	Liechtenstein
Romania	Mexico	**Turkey**	Poland
	Paraguay		Uruguay
	Senegal		Vanuatu
	Tunisia		
	UAE		
6	10	6	8

Table C2: The table shows countries that received ratings of non-compliant (NC) or partially compliant (PC) on at least 8 and no more than 11 key and core recommendations in mutual evaluation reports adopted prior to 2009. Countries in bold were blacklisted by the FATF.

Appendix D Covariate Comparison

	Below	Above	P-Value
Polity	2.5	4.2	0.68
GDP (log)	24.1	23.9	0.81
GDP per capita (log)	8.4	8.9	0.57
Treasury Bill Interest Rates	7.7	8.3	0.61
Financial Risk Rating	11.0	12.0	0.28

Table D3: The table compares covariates from 2008 for countries just below (rated 9) and just above (rated 10) the threshold. The results suggest that there were not significant differences between these groups of countries prior to the creation of the FATF blacklisting procedure.

Appendix E 2SLS Placebo Test for Financial Risk

	Dependent variable:
	Financial Risk
Blacklisting	−27.688
	(39.279)
FATF Member	−3.794
	(7.583)
Number of Failing Recommendations	−0.689
	(2.236)
Observations	145
F-Test on First Stage	0.774
Wu-Hausman	1.392
Note:	*p<0.1; **p<0.05; ***p<0.01

Table E4: *The Effect of Blacklisting on Financial Risk (2SLS - Placebo Test):* The table shows the results of a two-stage least squares analysis, where falling at or above the 10-failing-recommendation threshold is used as an instrument for blacklisting. The analysis examines the effect of being blacklisted at some point between 2010 and 2015 on financial risk ratings during the period of 2007 to June 2009 (before the blacklisted existed). The model includes year-fixed effects.

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