International Institutions and Indirect Market Enforcement:

Analyzing the Regime to Combat Terrorist Financing

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Puzzle

Trends:

- Increasing number of IOs regulating state policy
- Growth of regulatory institutions with no legal authority over states
- Regulatory institutions achieve policy change across issue areas

How do international institutions without enforcement authority punish non-compliance?

Findings

- **Argument:** Institutional monitoring provides information to market actors, who allocate resources away from non-compliant states.
- **Empirical Support:** Analysis of how the Financial Action Task Force's "blacklist" affects financial risk.
- **Conclusion:** Financial institutions punish states with deficient anti-money laundering and terrorist financing policies.

Understanding Compliance

Insights from existing literature:

1. Legal obligation
   - Reputational costs for violating (Keohane 1984, Simmons 2000)
   - Logic of appropriateness (Finnemore 1996)
   - Legitimacy (Hurd 2000)
2. Sanctions
   - Legalized dispute settlement
   - Denied loans, membership benefits
3. Mobilize domestic actors
   - NGOs as compliance monitors (Dai 2007)
   - Treaties shape legislative agendas, coalitions (Simmons 2009)

What if none of these pathways are available?

Theory: Indirect Market Enforcement

- Institutional monitoring provides credible information about domestic policy implementation.
  - Clearer signals (indicators, blacklists) –> more useful information
- Market actors use information to inform decisions about resource allocation.
  - Non-compliance by states may affect investor profits.
- Resource allocation –> punish non-compliers.

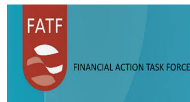
Market response to institutional monitoring raises costs of non-compliance.

Case: Terrorist Financing

Why Terrorist Financing?

- Policy Relevance: "Critical part of the overall campaign against al Qaeda," *9-11 Commission Staff Report.*

- Theoretical Relevance: The Financial Action Task Force, an informal international institution with no legal authority, has been very active in this area and is very effective.



The Financial Action Task Force (FATF)

- Created in 1989 to combat money laundering.
- 34 member states; 170+ affiliated countries.
- 49 recommendations on combating money laundering and terrorist financing.
  - Criminalizing money laundering and terrorist financing
  - Requiring customer due diligence
  - Reporting suspicious transactions
  - Freezing and confiscating assets
  - Maintaining a financial intelligence unit

No formal legal authority over members or affiliate countries.

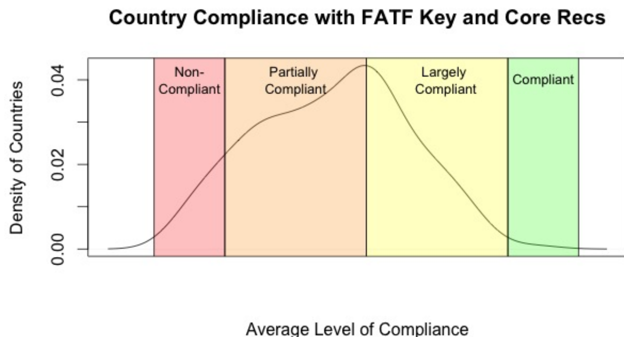
The Demand for Information

Why do financial institutions care if states comply with FATF recommendations?

- Government regulation
  - US companies subject to US laws on money laundering and terrorist financing
    - Customer due diligence procedures rely on country risk
  - US government punishes non-compliance
    - HSBC, Standard Chartered
- Reputation
  - Firms don't want to be seen as vehicles for criminal activity or terrorism
- Markets
  - Investors care about bank/company exposure to money laundering and terrorist financing risk

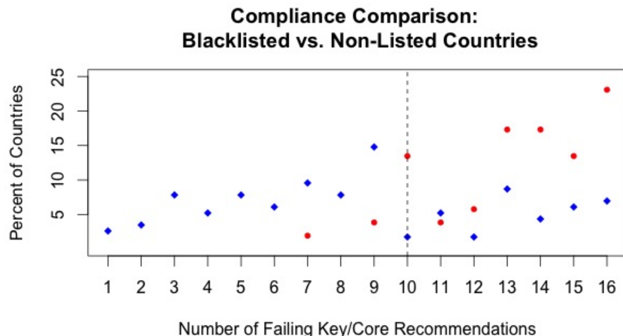
FATF Monitoring Reports

- Secretariat and peer countries evaluate compliance with 49 recommendations (16 identified as key and core)
- Third round of evaluations: 2005-2014
- 1 country evaluation per round



The Blacklist (2010 to Present)

- Tri-annual blacklists published in February, June, and October
- Eligibility for listing:
  - Monitoring reveals 10+ failing key/core recommendations
  - Non-cooperation with the monitoring process
  - Nomination by the FATF



Blacklisted Countries

Counter-Measures	*Enhanced Due Diligence*	*Warning*	*Ongoing Monitoring*
Iran	Algeria	Antigua and Barbuda*	Afghanistan
North Korea	Angola	Cambodia	Albania
	Bolivia*	Mongolia*	Argentina*
	Cuba*	Morocco*	Azerbaijan*
	Ecuador	Nepal*	Bangladesh*
	Ethiopia*	Nicaragua	Brunei Darussalam*
	Ghana*	Philippines*	Greece*
	Indonesia	Tajikistan*	Honduras*
	Kenya*	Trinidad and Tobago*	Iraq
	Myanmar	Zimbabwe	Kuwait
	Nigeria*		Kyrgyzstan*
	Pakistan		Lao PDR
	Sao Tome and Principe*		Namibia
	Sri Lanka*		Panama
	Syria		Papua New Guinea
	Tanzania*		Paraguay*
	Thailand*		Qatar*
	Turkey*		Sudan
	Vietnam*		Turkmenistan*
	Yemen		Uganda
			Ukraine*
			Venezuela*
2	20	10	22

Testing the Theory

Hypothesis: FATF blacklisting will increase investment risk.

Independent Variable: Blacklisting

- Dichotomous by month

Dependent Variables:

Financial Risk Ratings

- Ability to finance debt obligations
- Scale: 0 to 50
- Mean: 11.6
- SD: 5.0
- Analysis of 110 countries

Bond Yields

- Long-term government debt
- Perceptions of risk
- Mean: 5.1
- SD: 4.0
- Analysis of 51 countries

Treasury Bill Yields

- Short-term government debt
- Perceptions of risk
- Mean: 5.2
- SD: 5.3
- Analysis of 69 countries

Empirical Approach

1. Cross-Sectional Analysis

- Three dependent variables (financial risk, bond yields, t-bill yields)
- OLS regression with country and year-fixed effects
- Control for selection process

2. Instrumental Variable Analysis of Financial Risk

- Instrument: 10-failing-recommendation eligibility threshold
- Window: Compare countries that fail on 8 to 11 key/core recommendations
- 269 observations (21 countries, 4 blacklisted)
- IV assumptions:
  - Monotonicity
  - Exclusion restriction
  - Exogeneity of instrument (as-if random)

IV Specification: Probing Assumptions

Exclusion Restriction:

Blacklisting eligibility –> no effect on financial risk

- Country rating in window is exogenous to financial risk

Evidence:

- Eligibility based on reports adopted pre-blacklist creation –> no reason to sort
- Reports do not aggregate number of failing recommendations
- Key/core recommendations not identified until 2009

Additional support:

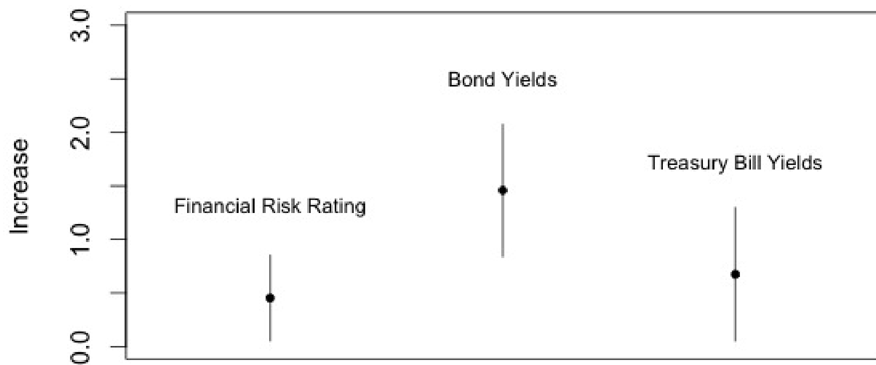
- Balance tests of covariates in 2008 –> countries just above/below threshold are comparable

Results: Effect of Blacklisting (2010-2015)

	Dependent variable:		
	Financial Risk	Bond Yield	T-Bill Yield
	(1)	(2)	(3)
Blacklisting	0.451*	1.458***	0.674*
	(0.243)	(0.371)	(0.379)
Number of Failing Recommendations	−0.136*	−0.152	−0.168
	(0.078)	(0.094)	(0.115)
No Evaluation	−1.619	−0.330	−0.182
	(1.008)	(1.010)	(1.581)
FATF Member	2.777**	−39.499***	−51.259***
	(1.341)	(9.597)	(11.350)
FSBB Member	−0.682	−356.262***	−458.218***
	(0.662)	(74.235)	(81.499)
Observations	1,515	628	854
R^2	0.974	0.954	0.909
Adjusted R^2	0.972	0.949	0.900
Residual Std. Error	2.054 (df = 1392)	1.482 (df = 567)	2.339 (df = 774)
F Statistic	426.741*** (df = 123; 1392)	191.026*** (df = 61; 567)	96.748*** (df = 80; 774)
Note:			*p<0.1; **p<0.05; ***p<0.01

All models include country and year-fixed effects.
Additional controls: financial account, GDP, GDP per capita, and polity
Explanatory variables lagged by one year

Blacklisting Increases Investment Risk



IV Analysis: Effect of Blacklisting (2010-2015)

	Dependent Variable: Financial Risk	
	9/10 Window	8 to 11 Window
Blacklisting	4.242*	5.640**
	(2.207)	(2.575)
Number of Failing Recs		0.482*
		(0.261)
FATF member	−2.883***	−5.485***
	(0.863)	(0.959)
Constant	10.583***	8.283***
	(0.492)	(2.424)
Observations	176	336
F-Statistic	38.7	46.7
Note:	*p<0.1; **p<0.05; ***p<0.01	

Models include year-fixed effects.

IV Analysis: Placebo Test (2007-2009)

	Dependent variable: Financial Risk
	8 to 11 Window
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

Instrument has no effect prior to creation of blacklisting procedure.

Conclusion

- Institutions enforce by providing information to market actors.
    - Market enforcement is effective:
      2/3 of blacklisted countries have “graduated” from the list.
- Increasing reliance on “informal institutions” may not weaken international system.
- Market actors as key players in fight against terrorism.