FROM BLACKLISTS TO BANKERS:
REPUTATION, MARKET ENFORCEMENT, AND
INTERNATIONAL COOPERATION

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Abstract

Under what conditions is reputation a driving force for international cooperation? This dissertation analyzes how international organizations (IOs) can use reputation and enforcement to generate widespread improvements in compliance. It theorizes that IO monitoring and assessment is most effective at incentivizing policy change when it combines reputational damage with market punishment. Information about state behavior that is credible, precise, and relevant to actors’ priorities is most likely to affect target states’ reputations. When markets are a relevant audience for such information, IO monitoring can drive “market enforcement,” whereby market actors reallocate resources away from states with damaged reputations. Market enforcement raises the costs of continued non-compliance and incentivizes widespread policy change.

I test this theory through an analysis of international cooperation on combating terrorist financing. Despite strong institutional rules and significant political support, as of 2009, less than 10 percent of countries had compliant laws on terrorist financing. Yet between 2010 and 2015, policy change suddenly became widespread, and today, almost every country in the world has laws that meet international standards. What explains this significant increase in cooperative behavior? The answer, I argue, is that an intergovernmental organization called the Financial Action Task Force (FATF) manipulated the reputational consequences of non-compliant behavior. By issuing a non-complier list, the FATF increased the reputational damage associated with uncooperative behavior and outsourced enforcement to market actors. Penalties from banks and investors incentivized domestic financial actors to become advocates for policy change, leading to widespread improvements in compliance.

Using original data, I illustrate this process through several different empirical approaches, including a regression discontinuity design that exploits a semi-exogenous change in FATF procedures to address concerns about endogeneity. I supplement this analysis with qualitative evidence drawn from interviews of financial industry professionals, government
officials, and IO bureaucrats, as well as participant-observation of two FATF-affiliate organizations. My findings draw attention to the importance of understanding how countries acquire reputations with specific audiences. They also illustrate the limitations of reputational damage alone in driving widespread compliance, and suggest markets are powerful potential allies for IOs seeking to incentivize policy change across states.
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Chapter 1

International Institutions, Reputation, and Market Enforcement

Whether bargaining over territory or negotiating an international agreement, issuing new debt or receiving foreign aid, governments care about how they are perceived internationally. But if the relevance of reputation is self-evident, identifying and explaining its precise impact is much more complex. How do country reputations form? When do they matter? These questions are not just of theoretical significance, but have implications for how policymakers confront the most pressing challenges of the 21st century. This dissertation offers an answer to such queries, providing a deeper understanding of how reputation affects compliance in the modern international system.

States have many reasons not to comply with international agreements. International organizations (IOs) and treaties may be closely aligned with state interests at inception, but over time, rules can deepen and state interests can diverge. In such circumstances, compliance becomes a cost-benefit calculation. IOs have the ability to shape this calculation. Although IOs rarely have independent enforcement powers, scholars have long hypothesized that reputational concerns may be important drivers of cooperative behavior. But it re-
mains unclear under what conditions IOs can actually manipulate reputational costs and use reputational damage to drive policy change.

This dissertation examines the link between reputation and international cooperation by analyzing an area where multilateral cooperation has grown exponentially over the last fifteen years: the global campaign to combat terrorist financing. In the years since 9/11, international counter-terrorism efforts have come to dominate news headlines. Terrorist attacks linked to transnational groups have proliferated, first due to Al-Qaida and now linked to the rise of the Islamic State of Iraq and Syria (ISIS). International actors have responded to this trend with a surge of activity. Governments have adopted more stringent anti-terrorism legislation, IOs have expanded their mandates, even non-profits have changed how they operate – all in service of countering terrorism and extremism worldwide. On the surface, the massive global effort seems unsurprising, even expected. Most governments and citizens oppose terrorism and terrorist agendas. Why wouldn’t there be widespread cooperation?

This rosy picture of harmonized preferences, however, is not representative of the actual issue area. Underneath superficial commitments, governments have actually been quite resistant to changing their counter-terrorism policies. While most governments are rhetorically supportive of cooperation, counter-terrorism policies themselves are actually much more controversial. In democracies, activists have opposed counter-terrorism laws because they encroach on civil rights and due process, while in more authoritarian countries, such laws have been used to target, imprison, and even torture opposition leaders. In resource-poor or low-capacity states, policymakers resist using resources or political capital to pass laws and expand bureaucracies when governments face much more urgent political priorities. As counter-terrorism efforts have extended into international finance, many countries have opposed more stringent financial regulations, due to concerns about the impact of such laws on banking costs and global competitiveness. And unlike in some issue areas, where
non-compliance by states generates few externalities, this type of uncooperative behavior on counter-terrorism can create global vulnerabilities.

Global policymakers thus face a difficult task: they must incentivize governments to overlook these domestic constraints and adopt stronger counter-terrorism policies. Over the last sixteen years, the United States and its partners have tried a variety of approaches to strengthen counter-terrorism cooperation, particularly in the realm of combating terrorist financing. Following the 9/11 terrorist attacks, several international institutions, most notably the United Nations Security Council (UNSC), adopted resolutions calling for the worldwide adoption of domestic laws criminalizing terrorist financing, but the international response was shallow and haphazard. Despite UNSC monitoring efforts, US pressure, and widespread technical assistance, most countries adopted laws that were weak and ineffective. Since 2010, however, a non-biding regulatory institution has used a public non-complier list to reverse this trend. Today, more than 100 countries have adopted comprehensive laws on terrorist financing, making it significantly more difficult for terrorists to access the international financial system.

This public non-complier list was successful at driving policy change because it combined reputational damage with market enforcement. Information about state behavior that is credible, precise, and relevant to actors' priorities is most likely to affect target states' reputations. When markets are a relevant audience for such information, IO monitoring can drive “market enforcement,” whereby market actors reallocate resources away from states with damaged reputations. Market enforcement raises the costs of continued non-compliance and incentivizes policy change. This dissertation is dedicated to exploring the relationship between information, reputation, and market enforcement in the context of international cooperation on combating terrorist financing.
1.1 When Does Reputation Matter?

International relations literature offers two distinct perspectives on how IOs can influence the policies of states. One approach emphasizes the role of information in improving compliance. Arguments center on how information reduces ambiguity, improves state capacity, and affects country reputations. An alternative perspective focuses on enforcement, highlighting how many international agreements are shallow and require little policy change. This enforcement approach argues that absent strong institutional enforcement, states are unlikely to adopt new laws and regulations that they would otherwise have opposed. Both strands of reasoning provide important insights into international politics, but neither fully explains the massive policy change on combating terrorist financing. After providing more details on each approach, I propose a new theory that links information and reputation with market enforcement. I then show that this market-based theory of reputation and enforcement explains how the international community has incentivized countries to adopt more stringent laws criminalizing terrorist financing.

Information and Reputation

International organizations promote cooperation between states by reducing uncertainty about the nature and requirements of an agreement, and about the behavior of other states. In the former case, IOs may work to clarify the terms of an agreement or promote its implementation. Compliance problems often do not reflect a deliberate decision to violate, but instead stem from ambiguity in treaty language, capacity limitations, and the fact that regulatory changes take years to adopt and implement (Chayes and Chayes, 1993, 188). In such circumstances, IOs can facilitate compliance by providing information to clarify rules or train government bureaucrats. For IOs like the United Nations and the International Monetary Fund, this type of information provision is a primary mechanism for assisting states and improving cooperative outcomes.
IOs may also promote compliance by reducing uncertainty about the behavior of other states. By participating in an international institution and taking on any associated costs, a state makes its commitment more credible and reassures other states about its intention to cooperate (Elkins, Guzman and Simmons 2006; Simmons and Danner 2010). IOs may also promote cooperation by providing information about state behavior, drawing attention to compliant and non-compliant policies. In this latter scenario, information provision is powerful because it creates reputational incentives for states to cooperate (Keohane, 1984). Reputational concerns may shape compliance through normative channels, as states are socialized into new types of behavior (Risse and Sikkink, 1999; Checkel, 2001) or through the anticipation of material punishment (Simmons, 2000).

Information about state behavior can have a powerful effect on a country’s reputation. While certain types of state behavior, such as defaulting on debt, issuing a threat, or testing a nuclear weapon, are clearly observable, many other types of behavior are harder to discern. Furthermore, international rules themselves are often quite ambiguous, leaving room for the implementation of commitments to vary across states. In such contexts, IO monitoring can be important for identifying non-compliance and damaging the reputations of uncooperative states. Providing information in certain formats, such as ratings, rankings, or blacklists, intensifies reputational effects because such formats invoke norms and invite cross-country comparisons (Kelley and Simmons 2015; Cooley and Snyder 2015; Kelley, 2017).

Information and reputation are important but incomplete mechanisms for explaining how IOs promote compliance. Countries may sometimes fail to meet commitments due to language ambiguity or capacity limitations, but such failures can also occur even when the international community devotes significant resources to supporting policy change. In the counter-terrorism realm, IOs worked together to clarify rules on combating terrorist financing, and made bilateral and multilateral technical assistance available to almost all states. Yet despite such support, less than 10 percent of countries had comprehensive laws
on terrorist financing as of December 2009. The lack of reputational costs associated with non-compliance might explain this trend. But then, a pressing question remains: why weren’t there reputational costs associated with deficient policies in this issue area? The global community had already identified combating terrorist financing and money laundering as top priorities. The United States, with the largest economy and banking sector in the world, already required that US financial institutions integrate information about country risk of money laundering and terrorist financing into financial decisions. And most importantly, information on non-compliance was already publicly available. The Financial Action Task Force (FATF) published detailed country assessments describing all the ways that countries failed to meet international standards on combating money laundering and terrorist financing; the FATF even worked with governments to assess the risk of money laundering and terrorist financing in each country. The US State Department also published an annual list of high-risk countries with deficient financial integrity policies. Such conditions seem ripe for reputation to matter, and yet most states suffered few penalties for failing to meet the rules.

For reputational damage to drive compliance, there must be costs associated with being labeled “non-compliant.” Yet, in many aspects of international politics, this is not the case. Bilateral relationships are often unresponsive to non-compliance because cooperation occurs across issue areas, and as Downs and Jones (2002) highlight, a single state may have many different reputations. A non-compliant state will only change its behavior in response to reputational concerns if there is an audience willing to treat the state differently, to extract some type of costs. In other words, reputation matters most when there is some kind of enforcement.

1The US State Department’s list of “Jurisdictions of Primary Concern” identifies countries where “financial institutions engage in transactions involving significant amounts of proceeds from all serious crimes,” while its list of “Jurisdictions of Concern” also considers the behavior of financial institutions, the risk of money laundering and terrorist financing, and several other factors (US Department of State, 2010). For more information on these lists, see: https://www.state.gov/j/inl/rls/nrcrpt/2016/vol2/253367.htm
Enforcement and Compliance

Given the role of coercive power in explaining why citizens comply with domestic laws, it is unsurprising that international relations scholars focus on enforcement as an underlying mechanism for compliance. Early work in game theory highlights the importance of state-to-state retaliation in response to uncooperative behavior (Axelrod 1984); tit-for-tat punishment proves to be the optimal strategy for states engaged in repeat-play games. In theory, a state could use such an approach to respond to violations of an international agreement, promoting a type of reciprocal enforcement that might explain compliance on trade agreements (Bagwell and Staiger 2002; Davis 2012) or with the laws of war (Morrow 2007). But in many issue areas, the benefits of continued cooperation and the costs of punishing every violation will make this a suboptimal strategy. Absent institutional or reciprocal enforcement, states may design shallow or vague agreements that require little policy change (Downs, Rocke and Barsoom 1996) or enter into agreements that reflect preexisting preferences (Von Stein 2005; Goldsmith and Posner 2006).

An alternative enforcement pathway is for citizens and non-state actors to hold governments accountable for non-compliance. Monitoring systems that reveal government non-compliance may inform and empower voters in democracies to punish governments electorally for certain types of violations (Dai 2007). International agreements may also embolden domestic audiences to hold their own governments accountable by creating litigation opportunities and encouraging domestic lobbying for policy reform (Simmons 2009). The power of this domestic accountability mechanism, however, is likely to vary across states. Prior to joining an agreement, governments may take into account the ability of domestic actors to monitor and enforce such commitments (Posner 2012); as a result, domestic monitoring may be highest in countries that are already inclined toward compliance.

Fearon (1997) notes that in cases where monitoring and enforcement are infeasible, states may commit instead to “vague agreements for political purposes,” perhaps to structure future negotiations (285).
Targeted enforcement is a powerful mechanism for driving compliance, but it rarely translates into widespread policy change. Few IOs have independent abilities to enforce, and domestic enforcement is much more likely to succeed in democracies, where countries have stronger rule-of-law norms and political institutions that encourage compliance. As cooperative obligations deepen, however, and non-compliance imposes externalities, targeted enforcement is insufficient for achieving cooperative gains. Indeed, [Downs, Rocke and Bar-soon (1996)] anticipated this problem twenty years ago, writing “cooperation...may begin with agreements that require little enforcement, but continued progress seems likely to depend on coping with an environment where defection presents significant benefits” (397). Rule clarifications, minor reputational consequences, even domestic enforcement – all may be insufficient when requisite laws are very costly and controversial. Under certain conditions, however, IOs may be able to generate widespread policy change, using the powers of monitoring to intensify reputational effects through markets.

This dissertation puts forward a new market-based theory of reputation and enforcement. According to this theory, market actors can play a key role in enforcing institutional rules and incentivizing compliance. When IO monitoring is credible, precise, and relevant to market priorities, market actors will use this information to update beliefs about non-compliant states and will reallocate resources away from states with damaged reputations. This “market enforcement” process raises the costs of continued non-compliance and drives states to change their policies.

1.2 A Market-Based Theory of Reputation and Enforcement

To understand the role of reputation in international relations, it is necessary to first understand how specific informational inputs shape a state’s reputation in a particular issue area.
State and non-state actors face informational asymmetries when engaging in international politics and so rely in part on foreign government reputations to guide decision-making. While existing theories suggest that reputation is linked to a state’s actions and behavior, my theory highlights how informational inputs are much more complex. Reputation may drive compliance, but this causal process is most likely when information is credible, precise, and relevant to the priorities of a targeted audience.

New information is more likely to affect the reputation of a target state when the source of the information is credible. Compared to states, IOs are less likely to reflect purely political or strategic calculations, and more likely to be perceived as having a legitimate right to evaluate state policies. Within the population of international organizations, institutions are likely to vary with respect to credibility – monitoring that is highly insulated from interstate politics (perhaps through delegation) is typically more credible than monitoring that is directly controlled by states. To the extent that credible monitoring requires access to state policy, IOs with interactive monitoring systems may also have advantages over non-governmental organizations, since IOs can draw on established relationships with government bureaucracies to extract information.

Reporting about a state’s non-compliant behavior is more likely to damage its reputation when the information is precise as well as credible. Precise, targeted information reduces uncertainty about a state’s specific behavior and also about how others are likely to view the state. Reputation is a conglomeration of these two views, which can be distinguished as “first-order” and “second-order” beliefs (Dafoe, Renshon and Huth 2014, 374). First-order beliefs reflect an actor’s observations about another actor’s characteristics or behavioral tendencies. Second-order beliefs are an actor’s beliefs about what a larger group of observers believes. First- and second-order beliefs may align or conflict, but information is at its most powerful when it moves both first- and second-order beliefs. While all types of IO monitoring

\footnote{ONeil (1999) terms this latter type of reputation “prestige,” which he defines in layman’s terms as “everyone knows that everyone knows” (p.195).}
may reduce ambiguity about state behavior, IO reporting is most likely to shape first- and second-order beliefs when an IO releases information through a rating, ranking, or blacklist.

The impact of information on a country’s reputation will also depend on it being relevant to a resource-endowed audience. When a group of actors makes resource allocation decisions on the basis of country reputations, this group is a natural target audience for IO monitoring. If IO information is relevant to this group’s priorities, reputation can become a powerful force for compliance. The logic for this is straightforward – information about uncooperative behavior matters most if an audience makes decisions based on this behavior – but it has important observable implications. First, in general, states should be less likely than non-state actors to update reputational evaluations based on new information. Bilateral relations are typically multifaceted and nuanced, and policymakers are likely to weigh any new information about specific state behavior against many other competing bilateral priorities. In contrast, non-state actors often have more narrowly focused interests. For this latter group, information related to one key priority has the potential to drive a larger shift in behavior.

The second observable implication is that the availability of potential enforcers is likely to vary across issue areas. Not all non-state actors have unidimensional or narrow preferences. Human rights NGOs may share the same overarching goal, but one group may deem certain violations as more important, and thus be more responsive to information about this specific topic. In the environmental realm, organizations are plentiful but narrowly targeted (Abbott, Green and Keohane 2016); new information may damage a country’s reputation, but only among that small set of groups that focus on the specific monitored behavior. Perhaps the best opportunity for information to align with actor preferences is in the financial realm. Market actors like investors, banks, and companies have, in theory, one key objective: to

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4Indeed, this may be why there is relatively little empirical evidence for the impact of reputation on international cooperation among states.
maximize profit. Information that signals a foreign country is a riskier investment prospect is likely to damage a country’s reputation with most market actors.

The availability of potential enforcers may also vary across time. Because an audience’s priorities determine its responsiveness to information, international or government action that shifts priorities can increase the probability that reputational damage drives enforcement. Government regulation can change the profit function for companies and investors. New donor priorities or heightened news coverage of an issue can change how non-profits allocate their resources across topics. Even shifts in consumer preferences can make public and private sector firms more interested in certain types of information. Because preferences are not fixed, reputation can become more or less important over time.

Reputational damage is a particularly powerful driver of widespread policy change when actors reallocate resources in response to information. Among the diverse array of non-state actors, markets actors like banks and investors are most likely to reallocate resources in response to new information because uncertainty is high and decision-making is interdependent. Market actors have incomplete information about foreign government capabilities and intentions. For this reason, they make decisions based on their beliefs about a foreign government’s past and future behavior, i.e. the government’s reputation. Market decision-making is also interdependent – financial actors must take into consideration not only their own views, but also how other competitors will make decisions about states. As a result, market actors have several incentives to reallocate resources based on information that damages a country’s reputation. When this process occurs, it can be a powerful driver for policy change.

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5 Here, I am assuming that, given equivalent rates of return, investors will always prefer the less risky environment. In reality, if investors perceive a country as a riskier investment prospects, the relative yield will increase in order to compensate investors for the additional risk. In such scenarios, the higher yield reflects decreased demand for the investment.

6 Resource allocation could be either toward or against the non-compliant states. Advocacy groups, for example, could increase pressure in response to information, while investors could shift money away.
1.3 Empirical and Policy Contributions

The remainder of this dissertation is dedicated to developing and testing this market-based theory of reputation and enforcement in the context of international cooperation on combating terrorist financing. The theory’s emphasis on credibility, precision, and relevance to an audience’s priorities explains why the FATF non-complier list has been so effective at spurring improved cooperation on combating terrorist financing. Prior to the list, the international community spent nine years trying to incentivize states to pass comprehensive laws that criminalized terrorist financing. During this period, the FATF released detailed monitoring reports on country behavior but these reports created few reputational consequences. Surprisingly, the US government’s own efforts, including an annual list of countries of financial integrity concern, also failed to generate policy change. It was only once the FATF targeted information about non-compliance to a relevant audience – in this case, markets – that information, reputation, and third-party enforcement all worked in tandem to improve compliance.

By testing a theory about reputation and compliance in this specific issue area, this dissertation makes several types of contributions. From a policy perspective, understanding the extent and nature of international cooperation on combating terrorist financing is essential for global security. Restricting terrorist financing is part of the core strategy for stopping violent extremism. My research shows that international efforts to build a robust legal regime against terrorist financing initially met with limited success; however, since the FATF issued its first non-complier list in 2010, international cooperation on this issue has improved significantly. The framework is in place – now states and IOs must evaluate the efficacy of this strategy.

[7] At a summit on this topic in February 2015, President Obama stated, “At a minimum, as a basic first step, countries have a responsibility to cut off funding that fuels hatred and corrupts young minds and endangers us all” [Obama 2015].
This dissertation also makes several empirical contributions. Scholars often encounter difficulties when trying to test the causal impact of information in the context of reputational theories, because the source and content of information does not vary over time. The over-time variation within this case, however, provides a unique opportunity to explore and test the boundaries of reputation as a driver for compliance. In Chapter 3, I trace the historical evolution of international cooperation on combating terrorist financing. My discussion illustrates that monitoring and information in the years immediately following 9/11 failed to generate reputational effects or lead to significant improvements in compliance. In contrast, once the FATF created its non-complier list, the reputational damage associated with being listed led to widespread policy change.

The case also allows me to overcome one of the core empirical challenges of studying the impact of IOs: endogeneity. Due to the FATF’s unique institutional structure and the exogenous shock of the financial crisis, a number of countries in the FATF global network found themselves unexpectedly eligible for the institution’s new non-complier list. In Chapter 4, I use a fuzzy regression discontinuity design to compare countries just above and just below the eligibility threshold, in order to more cleanly identify the causal impact of listing on market enforcement. This approach, combined with additional non-instrumented models in Chapters 4, 5, and 6, provides strong evidence in support of the theory. I also supplement my quantitative analysis with numerous interviews and several case studies to help identify the underlying causal mechanisms at work.

Finally, this research makes important theoretical contributions to the study of international relations. Scholars have long recognized the importance of reputation as a mechanism for driving international cooperation, but such accounts typically emphasize the causal link between the non-compliant state’s behavior and reputation. My research pulls apart this causal relationship, highlighting how the credibility and precision of information about state behavior may be as important as the behavior itself.
My theory also goes beyond existing accounts of information and reputation to specify conditions for when reputation is most likely to drive policy change. Information about non-compliance matters most when it is relevant to the priorities of a resource-rich audience. This emphasis on audience priorities can help explain why the strongest evidence for reputation as a driver of international cooperation comes from works that focus on domestic and non-state actors rather than states. States have complex decision-making frameworks that weigh many different factors. In contrast, non-state actors often base their actions on a small set of criteria, and if these criteria are violated, they are usually willing to impose costs on the violating states. Market actors are particularly likely to act in this manner because they allocate resources based in part on country reputations.\footnote{Market actors have incentives to consider a country’s reputation because they can be subject to “adverse opinion and negative publicity by operating in or doing business with countries noted for government corruption, human rights abuses, or military aggression...” \cite{Office of the Comptroller of the Currency 2016}.} IO monitoring is therefore most powerful when markets are the target audience for information.
Chapter 2

A Market-Based Theory of Reputation and Enforcement

Since the FATF cannot apply a penalty directly on you, they’ll tell your peers that you’re not behaving, and then every time there’s a financial relation or transaction, they’ll take special care to make sure you’re not contaminating their systems. Now there’s a cost involved, and the country doesn’t want to face this cost.

Former FATF President Antonio Gustavo Rodrigues

Between 2001 and 2008, Thailand experienced more than 1000 terrorist incidents, making it the fifth-most attacked country in the world. Although the Thai government estimated that domestic terrorists were receiving nearly a quarter of a million dollars per year, Thai officials failed to prosecute a single individual for terrorist financing (IMF 2007). Indeed, in 2007 when the International Monetary Fund (IMF) evaluated Thailand’s compliance with the Financial Action Task Force’s (FATF) nine special recommendations on terrorist financing, Thailand received failing ratings on all of the measures.

1 Author interview, 29 March 2017
2 According to Hewitt et al. (2012), Thailand experienced about five percent of all terrorist attacks worldwide, making it the country with the fifth highest number of terrorist attacks in the world.
Thailand’s story is typical of many countries during this period. Despite significant international efforts to combat terrorism following the 9/11 terrorist attacks, many countries made only cursory changes to their domestic policies. Capacity limitations, competing political priorities, and push back from domestic actors and civil society meant that countries around the world failed to meet international standards. Beginning in 2010, however, this picture started to change. Governments began passing new laws and setting up bureaucratic procedures to ensure that domestic banks and other financial institutions were complying with the new regulations. In Thailand, the parliament adopted comprehensive legislation on terrorist financing, implemented UN Security Council sanctions against terrorists, and began to prosecute individuals for terrorist financing. Other countries followed a similar pattern. What explains this burst of activity? After years of ignoring international standards, why did Thailand and so many other countries suddenly decide that it was time to comply with global rules? The answer is that the FATF, a non-binding intergovernmental organization, used a non-complier list to damage the reputations of uncooperative states. As reputational costs intensified, the costs of continued non-compliance increased, leading many states to change their policies.

This chapter lays out a theory of the conditions under which international organizations (IO) can use reputation to drive widespread policy change and improve cooperative outcomes. International relations literature describes two distinct pathways through which IOs can influence the policies of states. One approach focuses on the power of information to drive outcomes. Scholars highlight how IOs can provide information to reduce rule ambiguity and build state capacity (Chayes and Chayes 1993), or shape global norms (Wendt 1994). IOs may also provide information in a way that affects country reputations (Kelley and Simmons 2017). An alternative perspective focuses on enforcement, arguing that many international agreements are shallow and require little policy change (Downs, Rocke and Barsoon 1996; Von Stein 2005; Goldsmith and Posner 2006). When enforcement does occur, it is most
likely to be through domestic channels (Dai, 2007; Simmons, 2009; Johns, 2012; Mansfield and Milner, 2012), leading to disparate implementation across states.

The theory presented in this chapter merges these two perspectives, arguing that when IOs release monitoring that is *credible, precise, and relevant to an audience’s priorities*, information causes reputational damage and leads to third-party enforcement. IO monitoring is most likely to be credible when IOs develop a high level of technical expertise and are able to collect information on aspects of government policy that might otherwise be difficult to observe. While IOs publicize the results of monitoring and assessment in many forms, information that is clear and precise is most likely to damage the reputations of uncooperative countries. Quantifiable, public performance assessments like ratings and blacklists are particularly effective at generating reputational costs.

For IO monitoring to drive third-party enforcement, information must also be highly relevant to an audience’s priorities. Because state-to-state relationships are governed by a wide variety of considerations and IO monitoring usually reflects only one aspect of state behavior, bilateral relations are unlikely to shift significantly in response to reputational damage. In contrast, non-state actors have narrow preferences and decision sets, and are therefore much more likely to punish non-compliant states. Perhaps the best opportunity for information to align with actor preferences is in the financial realm. Market actors like investors, banks, and companies have one key objective: to maximize profit. Market actors are also particularly responsive to new information because uncertainty is high and decision-making is interdependent. If an IO signals information that highlights possible profit or investment risks, such information is likely to damage a country’s reputation with most market actors. In response, a “market enforcement” process occurs whereby financial actors reallocate resources away from non-compliant states, incentivizing policy change.

This chapter begins by discussing the conditions under which IO monitoring and assessment can drive policy change. I draw on longstanding work on the link between information,
reputation, and compliance, and on the emerging literature on global performance assessments. My argument suggests that when information is credible, precise, and relevant, it is most likely to damage the reputations of non-compliant states. Section 3 hones in on markets, explaining how institutions magnify reputational consequences when the relevant audience is market actors. I identify three conditions that increase the probability of market enforcement – ready substitutes, information asymmetries, and the threat of punishment for suboptimal decisions. Section 4 discusses the causal link between market enforcement and policy change, while Section 5 summarizes the general theory and lays out three broad theoretical propositions. Section 6 develops empirical expectations based on the theory, and Section 7 discusses the most likely alternative explanation: US power and pressure as drivers for policy change. The chapter concludes with a roadmap of the empirical analysis in subsequent chapters.

2.1 Monitoring and Assessment as Tools of Influence

IOs have long used monitoring and assessment procedures to influence state policy. As far back as the 1920s, the League of Nations collected and disseminated information on countries’ economic policies through its annual World Economic Survey. In the current era, many international institutions have robust monitoring and assessment capabilities that go beyond collecting statistics, and may include voluntary state reporting, collecting and distributing information, and assessing and publicizing instances of non-compliance. Some international institutions such as the International Labor Organization (ILO) even allow non-state actors to report instances of non-compliance directly to the organization.

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3 The IMF built on the League’s experience when it designed its own, broader monitoring procedures, and to this day, international institutions that work on global finance are particularly adept at collecting and disseminating data.

4 Once a country has ratified an ILO convention, it is required to submit reports detailing steps it has taken to implement the convention, and to submit copies of these reports to employers’ and workers’ organizations.
IO monitoring is most likely to impose reputational costs on non-compliant states when information is credible and precise. Reputational damage alone, however, is often insufficient to drive policy change when states have high costs of policy implementation. In such cases, IO monitoring must also be relevant to the priorities of third-party actors willing to serve as outside enforcers.

### 2.1.1 Institutional Credibility

IO monitoring can be a powerful tool of influence when it leverages a common institutional strength: credibility. Compared to states, IOs may have general advantages in terms of credibility because they are less likely to reflect purely political or strategic calculations. IO monitoring that is relatively insulated from interstate politics – perhaps due to delegation to a secretariat or to bureaucrats – is particularly likely to be credible. Although such acts of delegation limit state control, member states are often willing to make this tradeoff in order to take advantage of the technical expertise of bureaucrats (Hawkins et al., 2006). Such tradeoffs are particularly important for highly technical issues like nuclear security, or for issue areas like trade where conflicting legal interpretations may generate conflict between states. By delegating monitoring powers, states create an institutional body with the requisite level of expertise to support ongoing cooperation, and also enhance the credibility of such efforts.

The credibility of IO monitoring depends on both access to information about state policies and independence from state influence, yet IOs frequently face a tradeoff between these two objectives. If IOs regulate domestic policies that are not easy to observe – as is often the case with economic or security issues – they may only be able to monitor compliance with involvement from member states. For this reason, institutions will be most influential

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5 These organizations may comment on the government reports or they may send comments directly to the ILO (ILO, 2017).

5 Of course, bureaucrats can also be sources of inefficiency or self-defeating behavior. But even if, as Barnett and Finnemore (1999) argue, bureaucratic decision-making is biased by the bureaucracy’s institutional and normative incentives, such biases are less likely to be closely aligned with state power considerations.
when they rely on interactive evaluation systems, where monitoring procedures include a
combination of government reporting, direct evaluation, and final written assessments. The
Organization for Economic Cooperation and Development (OECD), for example, conducts
economic surveys to report on whether states follow its recommended best practices. This
lengthy monitoring process includes a detailed country questionnaire, two staff team visits
to the country, and several draft reports, with a final report adopted in the OECD plenary.
The entire process “is motivated by peer review and peer pressure” (Schäfer 2006, 74).

IOs have a comparative advantage in building interactive monitoring systems because
they can draw on established relationships to extract information from evaluated countries.
Indeed, because monitoring is so common across IOs, governments may be less likely to
resist IO monitoring since government bureaucrats are used to responding to IO requests
for information, meeting with IO officials, and receiving IO-provided technical assistance.
Over the long run, initial advantages in IO credibility can translate into improved access
and information, leading to more credible monitoring reports and enhanced institutional
credibility.  

Both states and non-state actors are more likely to view monitoring as credible when they
perceive the monitor itself as legitimate. Legitimacy, meaning a monitor has the “right to
rule” (Buchanan and Keohane 2006), enhances credibility because it intensifies reputational
effects. When a monitor is legitimate, a broader cross-section of actors are more likely to
update their beliefs based on information than when a monitor is illegitimate. IOs may
have initial comparative advantages in this regard; compared to states acting unilaterally

6 Of course, in some issue areas such as human rights or nuclear proliferation, government non-compliance
is much more likely to be intentional, in which case IOs will have more difficulty gaining access to relevant
information. Some international organizations have tried to overcome this challenge by establishing penalties
for denying monitors access; however, even when penalties are quite strong, as in 2009, when the UN Security
Council imposed sanctions on North Korea following the ejection of International Atomic Energy Agency
(IAEA) inspectors and a nuclear test (IAEA 2017), they may not be sufficient to remedy the problem.

7 The United Nations Human Rights Council, for example, is largely viewed as illegitimate because its
membership includes several states that are known violators of human rights. Because of this illegitimacy,
it is easier for states to dismiss Council reports as not credible.
or civil society organizations monitoring government actions, institutions are more likely to be perceived as legitimate monitors. IO legitimacy is enhanced by bureaucratization. As Barnett and Finnemore (1999) point out, bureaucracies “embody a form of authority, rational-legal authority, that modernity views as particularly legitimate and good” (p.707). IOs are governed by rules and procedures, which are administered by individuals with a high level of technical expertise – all of these factors serve to make them seem more legitimate than alternative arrangements.\(^8\)

IOs vary significantly with respect to credibility, depending on the issue area and the institutional design. Regulatory bodies are likely to be more credible monitors because they rely on technocratic expertise to monitor state behavior. In contrast, in highly politicized IOs like the UN Security Council, monitoring reports are likely to reflect underlying power dynamics. In such organizations, monitoring may highlight instances of non-compliance, but may also ignore bad behavior when it is politically convenient.\(^9\)

2.1.2 Precise Information

IO monitoring is most likely to impose reputational costs when information about state behavior is clear and precise. In the modern globalized era, where actors are often overwhelmed by the quantity of available information, how an international institution conveys its findings will intensify or weaken its impact. When an IO transmits a precise and unambiguous signal about the quality of state policy, its impact is likely to be much stronger than a detailed but unquantifiable report. Precision facilitates comparisons across countries. It also reduces uncertainty about a state’s specific behavior and about how others are likely to view the state. This reduction in uncertainty is important because reputation is a product of both

\(^8\)While it is true that in recent years, states and non-state actors have pushed to make international institutions more participatory, accountable, and transparent (Woods, 1999), such efforts have focused more on the reform of international organizations rather than the shifting of authority to private actors or individual governments.

\(^9\)Indeed, this may be one of the reasons that UN Security Council monitoring reports often focus on general trends in state behavior rather than individual instances of non-compliance.
“first-order” and “second-order” beliefs (Dafoe, Renshon and Huth 2014, 374). First-order beliefs reflect an actor’s observations about another actor’s characteristics or behavioral tendencies. Second-order beliefs are an actor’s beliefs about what a larger group of observers believes.\(^\text{10}\) For market actors in particular, both first- and second-order beliefs are important criteria for decision-making. Banks and investors, for example, must consider not only a foreign country’s financial practices but also how other market actors are likely to assess the risk of doing business with that country.

IOs can enhance the precision of monitoring through the use of global performance assessments – regularized, publicized reporting routines that facilitate peer comparisons, such as indexes, categorical assessments, or blacklists (Kelley and Simmons 2017). This type of monitoring is increasingly common, and is used by international organizations, states, civil society activists, and private actors. If a company wants to learn about the business environment overseas, it can consult the World Bank’s Ease-Of-Doing-Business index, Transparency International’s Corruption Index, or even annual rankings produced by Forbes and Bloomberg. Likewise, if an investor decides to purchase government debt from an emerging economy, she can consider everything from credit ratings to rankings on environmental, social, and governance factors.

Recent research suggests that global ranking and performance indicators can be influential tools of social pressure (Kelley and Simmons 2015; Cooley and Snyder 2015; Kelley and Simmons 2017). By design, global performance assessments are likely to lead to “uncertainty absorption” (March and Simon 1958) – although an IO may have assembled an index from a large body of evidence, the final product communicates only the IO’s inferences, not the original data. Unlike long, detailed monitoring reports that leave ample room for interpretation, audiences can use indicators and ratings as a type of heuristic that guides

\(^{10}\) O’Neill (1999) terms this latter type of reputation “prestige,” which he defines in layman’s terms as “everyone knows that everyone knows” (p.195).
decision-making in predictable ways. Through “the magic of numbers,” IO evaluations are suddenly more certain and objective (Merry 2011, S84).

Kelley and Simmons (2017) argue that global performance assessments are most likely to have an effect when they present new information or actionable policy advice; however, the authors acknowledge that sometimes rankings are useful even when performance strengths and weaknesses are already well-known. A government is likely to care more about its policy weaknesses when it is also ranked 150 on a list – and indeed, the public is much more likely to care as well. These reputational consequences may be intensified when countries are grouped into categories since such processes can create a “peer effect,” whereby countries are judged not just for issue non-compliance but also by the other countries that are also included on the list or in the category (Gray 2013; Brooks, Cunha and Mosley 2014). In the case of a blacklist, this “peer effect” may be closer to a “lowest-common-denominator effect” (Morse 2017), where countries are judged by the worst of the group. After the FATF included Antigua and Barbuda on its non-complier list in February 2010, for example, the leading opposition leader criticized the ruling party for the fact that Antigua and Barbuda was on a list with Nigeria, Sudan, Ukraine, and Myanmar 11.

2.1.3 Direct Impact of Monitoring on States

IO monitoring is likely to have a strong impact on policy implementation when non-compliance stems from rule ambiguity. When IO rules or standards are complex or relatively unfamiliar to states, monitoring reports can improve implementation by helping states learn how to translate general obligations into specific laws and regulations (Chayes and Chayes 1993). This process can occur as an IO collects information about

11 “The Labour Party government and its representatives worked diligently in advance of the issuance of the FATF lists in 2000 and 2001 to ensure that Antigua and Barbuda was in full compliance with required standards before the FATF identified delinquent jurisdictions...Now, under the UPP, we are on a list with Nigeria, Sudan, Ukraine, and Myanmar.” Statement by Lester Bird, Leader of the Antigua Labour Party, in February 2010, after the FATF listed Antigua and Barbuda.
non-compliance from the state, evaluates compliance, and publishes monitoring reports. Significantly, states may also learn how to interpret rules from observing how IOs monitor other states. International courts are particularly effective in this regard. Although they may serve an enforcement purpose, international court decisions also function as a type of monitoring, providing information to states about how to interpret rules and what kinds of behavior are acceptable. Even in the context of an institution like the World Trade Organization (WTO), where precedent is officially non-existent, scholars have shown that states treat WTO panel and Appellate Body decisions as though they have precedential value (Busch 2007; Busch and Pelc 2010; Brutger and Morse 2015).

In issue areas where the reputational costs of non-compliance are high and where the costs of policy change are relatively low, IO monitoring may also have an effect through normative and reputational mechanisms. Keck and Sikkink (1998) show that transnational advocacy networks across states can promote policy convergence through the spread of norms and by pressuring target actors to adopt new policies. In issue areas where such networks operate, IO monitoring can provide information that facilitates activism and political mobilization around compliance. Other scholars have argued that IO “naming and shaming” can be effective in the areas of human rights (Lebovic and Voeten 2006; Hafner-Burton 2008) and human trafficking (Kelley and Simmons 2015; Kelley 2017). In such cases, IO monitoring serves not only to generate international reputational costs but also to damage a government’s reputation with its domestic audience. In contrast, when an IO monitoring report reveals non-compliance on a more technical, less politically salient issue, a government is unlikely to suffer any type of reputation cost with its domestic audience. Leaders may also mute domestic reputational costs by dismissing monitoring reports as biased or illegitimate, as Israeli Prime Minister Netanyahu did after the UN Human Rights Council released a report accusing Israeli Defense Forces of war crimes (Sharon 2015).
Even when IO monitoring reduces rule ambiguity and generates reputational costs, however, its impact on policy change may be limited if non-compliance reflects institutional commitments that do not match government objectives. Such a disconnect may occur for either institutional or domestic reasons. States may commit to agreements that lack explicit enforcement provisions, intending on weak or non-existent compliance; in such instances, public monitoring and assessment is unlikely to generate significant improvements in behavior.\(^{12}\) Institutional commitments may also deepen over time, and states may find themselves facing a tradeoff between the costs of continued non-compliance and the costs of implementing a policy that produces few functional cooperative gains.

Domestic characteristics like regime type and civil society mobilization may also affect cooperative behavior, increasing the incentives for non-compliance. A substantial body of scholarship has shown that regime type affects a country’s propensity to cooperate and comply with international rules.\(^{13}\) It may be easier for democratic countries to interpret and absorb international agreements into domestic regulation (Fisher, 1981); it may also be easier for countries with established legal systems to abide by international law (Slaughter, 2005). But while democratic countries may be more willing to comply with international agreements, adopting new laws and implementing legislation is likely to take longer in such countries. Parliamentarians have competing legislative priorities, and unless an international agreement is particularly salient for domestic audiences, legislators are likely to focus on more popular agenda items first.

Non-state actors like interests groups or non-governmental organizations (NGOs) may also affect cooperative behavior, working to support or oppose policy change depending on whether they are hurt or helped by non-compliance (Dai, 2002). While NGOs may support international commitments on the environment (Raustiala, 1997; Von Stein, 2008) and hu-

\(^{12}\) There is ample evidence of this trend in the human rights issue area. See, for example, discussions in Hathaway (2002) or Powell and Staton (2009).

\(^{13}\) See, for example, Helfer and Slaughter (1997), Raustiala and Victor (1998), Martin (2000), or Mansfield, Milner and Rosendorff (2002).
man rights (Simmons 2009), in economic areas like trade, they may work in the opposite direction (Downs and Rocke 1995; Rosendorff and Milner 2001). Even in a seemingly non-controversial area like combating terrorism, governments in many countries have encountered significant domestic opposition when pushing through new legislation.\textsuperscript{14}

All of this literature suggests that, even when IO monitoring increases the ability of governments to comply with their commitments, governments may still be unwilling to change their policies. Institutional commitments may not match government objectives or policy change may be too costly to implement. Domestic actors may have competing priorities, or in some cases, may actually be opposed to meeting institutional rules or standards. In all of these cases, IO monitoring alone is likely to be insufficient to drive compliance.

2.1.4 Relevance to Third Parties

Credible and precise institutional monitoring may damage a state’s reputation, but such effects are intensified when information is highly relevant to a particular audience. The logic for this is straightforward – information about non-compliance is most likely to damage a country’s reputation when an audience makes strategic decisions based on this behavior. Because states decide how to treat other states based on a complex array of factors, information is unlikely to impose significant reputational costs via state-to-state relations. In contrast, market actors and advocacy groups often have more narrowly focused interests; information related to one key priority has the potential to drive a larger shift in behavior.

Given this decision structure, the availability of potential enforcers is likely to vary across issue areas. Not all non-state actors have unidimensional or narrow preferences. Human rights organizations may share similar goals, but one group may deem certain violations more important than others, and thus be more responsive to certain types of information. In the environmental realm, organizations are often narrowly targeted (Abbott, Green and

\textsuperscript{14}Whitaker (2007) identifies 13 developing countries where post-9/11 counter-terrorism legislation passed only after extensive debate or controversy.
as a result, new information may damage a country’s reputation, but only among the set of groups that focus on the monitored behavior. Perhaps the best opportunity for information to align with actor preferences is in the financial realm. Market actors like investors, banks, and companies are oriented around maximizing profit. Information that signals a foreign country is a riskier investment prospect is likely to damage a country’s reputation with most market actors.

As audience preferences change over time, reputation can become more or less important. If international or government action leads an audience to value a new type of information, IO monitoring on this topic is more likely to generate reputational damage. Government regulation, for example, can incentivize firms to take into account certain types of country risk, such as corruption or money laundering. International action, even as simple as goal setting, may lead non-profits to allocate resources differently across topics. Even semi-exogenous changes like global pandemics or climate change may change how audiences evaluate risk. In lieu of recent climate-change related disasters, for example, companies or investors may be increasingly interested in a country’s risk profile for such events, and may change how they allocate resources based on such information. As a result of such shifts in audience preferences, IO monitoring may lead to more or less reputational damage over time. This process will be most influential in driving policy change when reputational damage leads actors to reallocate resources based on new information.

2.2 Magnifying Influence Through Markets

When an international institution monitors a policy issue that affects the profit considerations of market actors, its reports may influence how these third parties allocate resources to non-compliant states. A bank deciding whether to open foreign branches or establish business

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\textsuperscript{15}The United Nation’s adoption of the Millenium Development Goals oriented non-profit activities in this manner.
relationships with banks in another country may consider FATF reporting on the country’s money laundering or terrorist financing risk. Similarly, investors purchasing sovereign debt may analyze not just a country’s credit rating, but also World Bank data on political institutions and good governance\textsuperscript{16} In such cases, IO monitoring is influential because it reduces information asymmetries about the potential risks and gains of specific allocation decisions.

Who are market actors? This intentionally broad category applies to all legally operating profit-driven non-state actors who allocate resources in cross-border transactions that affect market prices\textsuperscript{17} “Market actors” thus includes traditional financial actors like banks, investment firms, and companies. The key commonality among this group of actors is that decision-making is largely unidimensional – profit maximization is the clear guiding principle. In contrast, while IOs, non-profits, and consumers may also participate in the global economy, such actors have multiple, often competing considerations for how they allocate resources.

Market actors are likely to be particularly influential in affecting the policy calculations of states because they make allocations that affect governments. Governments gain access to capital through sovereign debt markets, and even loans through institutions like the World Bank and IMF may be partially tied to private investors. Indirectly, market actors may also influence government resources through their effects on the economy. Cross-border bank transactions and transnational supply networks facilitate trade, while foreign direct investment stimulates economic growth. For all of these reasons, governments are likely to be particularly responsive to IO-driven market enforcement.

IO monitoring is most likely to lead to market enforcement under three conditions. First, market actors have ready substitutes available, i.e. they can choose how to allocate resources across multiple countries. Second, market actors engaged in global transactions face some

\textsuperscript{16}Indeed, some scholars argue political risk is as important a determinant of sovereign spreads as credit ratings or fiscal stability (Cuadra and Sapriza \textsuperscript{2008}, Baldacci, Gupta and Matti \textsuperscript{2011}).

\textsuperscript{17}This definition intentionally excludes illicit market actors like drug cartels.
type of information asymmetry, where they do not have complete insight into foreign government policies, and IO monitoring improves information. Third, there are external financial consequences for market actors that do not adequately integrate information. Each of these conditions is addressed in the next section.

2.2.1 Ready Substitutes

For IO monitoring to influence how banks or investors allocate resources, market actors must be able to choose between multiple, cost-effective substitutes, or, in this case, countries. In the most general terms, as the number of countries that offer a particular investment opportunity increases, IO monitoring should be more likely to lead to market enforcement. The logic for this argument parallels literature on price competition in microeconomics. Under monopoly conditions, a single company can be a price setter, choosing what to charge consumers based solely on its own supply and demand calculations. As more firms enter the market, however, each individual firm will have less control over the unit price for a good because consumers will switch to the cheapest price available. Similarly, if only a small number of countries in the world provide access to a resource, companies that are looking to extract that resource will be much less responsive to the new information. As more countries offer a particular investment opportunity or financial product, however, market actors should be increasingly willing to substitute across countries.

Whether market actors can find readily available substitutes is also likely to depend on the sunk and future costs within a specific industry. Certain types of investors, such as stock, commodity, or bond traders, are unlikely to have large country-specific sunk and future costs – they can purchase and sell stocks easily from day-to-day. For banks, such costs are likely to vary – large multinational banks may have branches around the globe, requiring large initial capital investments, or may operate internationally through correspondent banking
Companies are also likely to vary in this respect; while it may be relatively costless for a technology company to relocate a programming office, large manufacturers will face more significant losses for factory relocation. Across all three types, however, as opportunities for substitution increase, market actors should be more willing to reallocate resources based on IO monitoring.

### 2.2.2 Markets, Information Asymmetries, and Reputation

Market actors almost always face some type of information asymmetry about foreign-government policies that could impact bottom-line concerns. Scholars who analyze financial reporting and disclosure point out how information problems and incentives to misrepresent may impede the optimal allocation of resources in an economy. Because companies want the best possible terms for capital and investment, they have incentives to hide any potential deficiencies from investors. Information intermediaries, such as financial analysts and rating agencies, will attempt to remedy this asymmetry by providing more complete information about the true performance of a company (or government). Such intermediaries, however, often have competing incentives that make them unlikely to provide complete information. A substantial body of scholarship has shown that rating agencies often fail to provide complete information about the true quality of an investment, due to conflicts of interest between rating agencies and investors, rating-contingent regulation, and an unwillingness of rating agencies to frequently update ratings.

The information asymmetry condition is perhaps best illustrated through the example of risk premiums on sovereign debt. When investors purchase government debt, they make a cost-benefit calculation, weighing the returns on the investment (as indicated by the yield)
against the possible risk of default. Because investors can choose to buy debt from many
different countries, the yield spread – that is, the difference between the yield that investors
demand for a low-risk benchmark bond (like US treasuries) and the yield for treasuries
of similar length from other countries – reflects investor risk perceptions. Investors demand
higher yields for countries that are more likely to default. Research suggests yield spreads are
affected by global economic factors like the performance of the US stock market and investor
expectations of short-term stock market volatility (Longstaff et al., 2011), the fiscal policies of
individual governments (Afonso and Strauch, 2007), and internal political dynamics (Moser
2007). While it might be possible for investors to have clear insight into the global economy
and even a government’s spending patterns, it is much harder to obtain good information
about the quality and capacity of the leadership.

In such a context, a country’s reputation becomes very important. Political science
research has highlighted the extent to which risk premiums are affected by a country’s rep-
utation. Tomz (2007b) suggests investors lend money based on beliefs about a government’s
“type.” Specifically, investors observe a government’s repayment record over the course of
many years, and take this into account when deciding whether to buy debt (Tomz, 2007b). Other research suggests that investors may make judgments based on more surprising fac-
tors like a country’s membership in international organizations (Gray 2013) or their views
of similar “peer” countries (Brooks, Cunha and Mosley 2014). Given the importance of
reputation in determining resource allocation, governments may seek to cultivate a particu-
lar reputation through public statements (Fearon 1994 1997), international commitments
(Simmons 2000), or new legislation. While such efforts may improve a country’s reputation,
they are more likely to be effective if they are validated by an independent entity like an
IO. For example, when Georgia wanted to improve its image as a destination for foreign
direct investment (FDI), the government adopted a wide array of policy reforms designed
to improve its ranking on the World Bank’s Ease-Of-Doing-Business index. In one year, it
jumped from 112 to 37, leading to an influx of FDI (Schueth, 2015). Investors may have viewed Georgia’s actions as more credible signals of the business environment because such changes were independently verified by the World Bank.

IO monitoring, then, is most likely to influence market decision-making when it affects a monitored country’s reputation among market actors. There are two ways that this can happen. First, international institutions may be able to provide novel, nuanced insight into specific policy issues, due to the breadth of reporting, technical expertise, and access. Second, institutional monitoring may reduce ambiguity about how others will view particular countries, which may influence market decision-making regardless of the informational content. While each of these pathways may occur individually, IO monitoring is most likely to lead to market enforcement when both processes are present.

**Novel Information**

IOs are credible sources of new information for market actors under three conditions. First, an IO must provide comprehensive reporting on policy implementation across a wide range of states. Second, an IO should leverage institutional expertise to provide nuanced insight into particular policy issues. Third, an IO has a relative advantage in gaining access to sensitive information through contacts with the government.

IO assessments on compliance are most likely to influence markets when an IO has reviewed government policies in all member states. The breadth of such monitoring efforts means that an IO is able to provide information that covers states that want to be monitored and also states that agree to monitoring only because of political or institutional pressures. IOs often have unique advantages in this regard, because they offer opportunities for states to link cooperation across issue areas (Keohane, 1984); as a result, governments may reluctantly submit to monitoring in one area to gain other types of cooperative benefits. When this occurs, IOs can provide more comprehensive monitoring, which allows market actors to compare performance across countries.
Institutional monitoring and assessment will also be influential when it provides more detailed insight into a particular policy issue than is typically available to market actors. Highly technical IOs with extensive bureaucracies are particularly likely to provide new insights or offer alternative interpretations of state behavior that will be useful for market actors. In particular, by reporting on sub-issues, IO bureaucrats can leverage a comparative advantage over alternative monitors like rating agencies, which have to consider hundreds of different factors when deciding how likely a government is to repay its debt. In contrast, IO monitoring may provide nuanced insight into a small set of specific factors that may be of interest to some investors.

IO monitoring and assessment is also more likely to influence market actors when IOs have direct access to information that is difficult for market actors to find. As discussed earlier, IOs are most successful when they gain a certain level of cooperation from states. Governments may be incentivized to cooperate with IOs if there is ambiguity within governments about the rules or the extent of compliance, or if they want advice about how to implement specific policies. In such instances, monitoring may serve to unearth information but also to build the domestic capacity of governments to understand and implement international regulations (Chayes and Chayes 1993). The IMF, for example, conducts annual visits to member countries where IMF staff meet with government and central bank officials to discuss monetary, fiscal, and regulatory policies, as well as structural reforms. As part of this process, IMF officials aim to both evaluate countries and provide expert policy advice. A similar process occurs in the IAEA, which provides technical assistance to support nuclear technology and also verifies that member states have in place safeguards to protect nuclear materials. These types of “evaluation-and-technical-assistance” programs facilitate a comparative advantage of IO monitoring. Whereas market monitors may be solely inter-

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ested in collecting information, IO monitoring often includes capacity-building and technical assistance, which incentivizes states to allow monitoring teams more access to information.

Focal Points

IO monitoring can come in many forms, from long, detailed country-specific reports to general descriptions of cooperation within regions. Certain types of information, however, are more likely to lead to market enforcement because they are more effective focal points for market actors. For profit-based market actors like banks and investment firms, the optimal allocation of resources depends not only on the true value of a commodity, but also on the conventional wisdom surrounding a particular acquisition. Investors, banks, and companies learn about conventional wisdom through public information. Amato, Morris and Shin (2002) document how public announcements by a Central Bank not only convey information about the underlying fundamentals of the economy but also serve as a focal point for the markets as a whole. Robert Shiller, writing about the role of the media in driving major market movements, describes how news coverage of the 1995 earthquake in Kobe, Japan led the Japanese Nikkei index to lose over eight percent of its value, while also causing stock indices in London and Paris to fall as well. In Shiller’s view, “the best interpretation of the effects of the Kobe earthquake on the stock markets of the world is that news coverage...engaged the attention of investors, prompting a cascade of attention that brought to the fore some more pessimistic factors” (Shiller, 2015, 109).

When IOs publish monitoring reports, they contribute to the public discourse about the investment potential and risks of monitored countries. Although all types of monitoring can reduce information asymmetries, monitoring reports that send clear, unambiguous signals about policy are more likely to serve as focal points for markets. Global performance assessments like indicators, rankings, and blacklists are well-suited for moving market actors

\[21\] See, for example, the economics literature on strategic complementarities, which suggests investors with shorter time horizons or significant illiquid assets optimize decisions based in part on expectations of how other investors will evaluate options.
from a state of uncertainty, where it is impossible to “quantify the prospects for events that may or may not happen in the future” [Nelson and Katzenstein 2014, 362] to a state of risk, where actors can assign probability distributions to different outcomes. In some cases, monitoring and assessments may serve as focal points despite containing little new information. Credit rating agencies (CRAs), for example, often follow market movements, but can nonetheless act as “triggers” for downward spirals. [Abdelal and Blyth (2015)] illustrate this relationship by tracking market movements of the Greek sovereign during the financial crisis, finding “the downgrades and the credit spreads reinforced one another in a vicious spiral; the two processes informed on another, telling the other what both the CRAs and the markets already knew” (52-53). When an international institution publishes a country ranking or a blacklist of states, this type of monitoring should make it easier for market actors to predict how their competitors will respond, encouraging herd decision-making.

2.2.3 Punishing the Punishers

Market actors are more likely to act as enforcers when third parties might punish them for failing to take such action. Almost all market actors are accountable to third parties such as shareholders and government regulators. When these third parties are willing to punish market actors for failing to integrate information about country risk into their decisions, this process of secondary enforcement will incentivize market enforcement. Secondary enforcement can come in the form of regulatory action, reputational damage, or a loss of shareholder confidence. While all three forms can occur in tandem, each process is distinct from the others.

Most large financial centers have regulations that dictate how banks, investors, and companies can conduct business abroad. Regulations may parallel domestic laws on matters like antitrust or worker safety, or may be specifically designed for operating in foreign context. The US government, for example, has laws forbidding the bribery of foreign officials and
sanctioning imports or exports to certain countries or foreign companies. As the business environment has globalized, similar laws on bribery and sanctions have become increasingly common across the globe.\textsuperscript{22}

When domestic laws require market actors to take into consideration certain risks of doing business abroad, market actors face increased incentives to integrate IO monitoring into decision-making to avoid domestic enforcement. Although governments enforce many different types of foreign business laws, enforcement has been particularly pronounced against violations of anti-money laundering laws. The US government has levied billions of dollars in fines against banks for violating money laundering laws, including a massive 1.9 billion dollar fine against HSBC \textsuperscript{[US Department of Justice} \textsuperscript{2012}]. In January 2017, UK authorities fined Deutsche Bank 163 million pounds for carrying out suspicious transactions that shifted money from Russia to offshore bank accounts \textsuperscript{[Martin} \textsuperscript{2017}]. Because the United States and the United Kingdom are home to largest financial centers in the world, enforcement action by these two governments creates ripple effects throughout global finance, increasing incentives for market actors to pay attention to the risk of money laundering in foreign countries.

Market actors should also be more willing to integrate IO information into their decision-making structure when such information suggests that certain types of transactions could damage their reputations if made public. Banks or investors may be concerned not just with immediate profits, but also with the long-run image of their companies. As the recent Wells Fargo case has shown, when banks adopt normatively problematic policies, they suffer significant declines in customer support, even months later.\textsuperscript{23} It is not hard to imagine a bank or investment firm facing similar, or perhaps worse, repercussions from customers.

\textsuperscript{22}US leadership on combating bribery is a quintessential example. For many years, the United States was effectively the sole country in the world to prohibit its businesses from bribing foreign officials; however, in the mid-1990s, civil society activists began to push to globalize anti-bribery rules, and in 1999, the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions entered into force \textsuperscript{[Corr and Lawler} \textsuperscript{1999}]. Today, the convention has 41 signatories, including most of the major economies in the world. Signatories include all OECD members, as well as Argentina, Brazil, Bulgaria, Colombia, Russia, and South Africa.

\textsuperscript{23}In September 2016, the news media began reporting that Wells Fargo bank employees had opened or applied for more than 2 million bank accounts or credit cards without customers’ knowledge. Six months
for facilitating terrorist financing. Reputational damage may also affect how other market actors interact with a bank or company; indeed, Verhage (2011) finds that many bank compliance officers worry most about interbank reputation protection. Similarly, companies might calculate that if they are publicly criticized for using child labor or circumventing environmental standards, they could lose contracts or have trouble obtaining new loans.

The final way that market actors themselves may be punished for failing to integrate IO monitoring into decision-making is through investors or shareholders. The prospect of shareholder punishment amplifies profit-based incentives – not only do banks or companies want to maximize profit, the leadership of such entities wants to minimize the chance that they are punished for poor returns or badly-designed investments. But while investors and shareholders often focus their energies on short-run profits, they may also care about exposure to different types of risks. It is for this reason that the financial services industry offers several different types of indices and ratings systems that evaluate a company’s exposure to environmental, social, and governance risk. Large asset managers use such indices to judge risk exposure, often shifting resources away from companies that are near the bottom of the spectrum (Interview with MSCI Executive, 25 September 2015). As a result, even when a company does not suffer a decline in profit, its leadership may still worry about shareholders divesting if it is overly exposed in risky environments.

2.3 From Market Enforcement to Policy Change

If IO monitoring leads market actors to change how they allocate resources to non-compliant states, how does this affect the political calculations of governments? When a government views IO monitoring as illegitimate, a leader might publicly contest the findings, criticizing the methodology or hinting at political bias in an attempt to undermine the validity of later, the bank was still experiencing a significant decline in credit-card applications and requests for new checking accounts (Keller 2017).
If such efforts are widespread, they may either relieve some market pressure, or convince the IO to change its methodology or abandon a particular approach. This dynamic reportedly occurred with the old FATF non-compliance process, whereby in 2000 and 2001 the FATF publicly labeled a handful of non-FATF member countries with significant anti-money laundering deficiencies as “uncooperative.” Although the process succeeded in generating policy change, the FATF stopped adding countries to the list in 2001 because the list was widely criticized as illegitimate (Hülßse 2008).

States might also try to improve rankings by “gaming” the system. If IOs are legitimate but prone to political influence, governments might try to relieve market pressure by lobbying the IO for a rating improvement. If standards are easily achievable, a state might identify quick legislative or regulatory changes to address underlying deficiencies. Such strategies are particularly likely if there are market benefits associated with positive ratings. For example, because politicians and the media perceive the World Bank’s Ease-of-Doing Business index as affecting FDI inflows (Jayasuriya 2011), governments work to improve their ratings by crafting new policies that address specific Ease-of-Doing-Business criteria. This type of gaming behavior, where countries target improvements toward external evaluators, can occur even absent strong market incentives.

When IO monitoring is credible, precise, and relevant to market actors, however, reputational damage can lead to market enforcement and incentivize widespread policy change. Countries will vary in how responsive they are to these processes; domestic institutions and politics are likely to influence how leaders allocate resources among competing policy priorities (Milner 1997; Moravcsik 1997; Rickard 2010). However, one of the strengths of market enforcement is that international banks and investors typically have direct access to

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24 Theoretically, outlier states could actually embrace and revel in poor ratings. Countries that are significant money laundering destinations, for example, could view a negative FATF report as likely to increase illicit finance. Empirically, however, there is not much evidence for this type of “race-to-the-bottom” (Oates 1972) regulatory competition (Basinger and Hallerberg 2004).

25 See, for example, the discussion in Kelley (2017) of how countries work to improve their ratings on the US government’s Trafficking-in-Persons Report.
the leader’s “winning coalition,” i.e. those people whose support is essential to maintaining power (Bueno de Mesquita et al. 2003). The domestic banking community and the central bank are part of the winning coalition in many countries, creating domestic allies for policy change. In countries where market integration is high, domestic banks are likely to be an influential part of the economy and will have significant pull with the government. Market integration thus intensifies reputational effects, and incentivizes compliance.

2.4 Summary and Theoretical Propositions

When IOs produce monitoring that is credible, precise, and relevant to an audience’s priorities, information imposes reputational costs on non-compliant states. IOs are more likely to be credible monitors when they are removed from political oversight, perhaps through delegation, and when they have significant technocratic expertise. Institutional legitimacy may also enhance credibility and increase the reputational costs of monitoring reports. When a credible IO sends a clear and precise signal about a state’s uncooperative behavior, IO monitoring is more likely to damage the state’s reputation. For reputational damage to lead to policy change, however, the information must also be relevant to an audience willing to reallocate resources on the basis of country reputation. While states rarely update bilateral strategies based on one aspect of policy, non-state actors are more likely to have narrow decision-making criteria. As a result, non-state actors should be most willing to act as outside enforcers for institutional rules.

IOs can intensify the impact of monitoring by highlighting issues of interest to market actors. This process is most likely to occur under three conditions: (1) market actors have readily available substitutes across countries; (2) market actors face some type of information asymmetry and IO monitoring improves information; and (3) market actors will be punished financially if they do not adequately integrate new information. Given this set of factors, market actors like banks and investors may use IO monitoring to reallocate resources away
from non-compliant states. This transnational market enforcement process will raise the costs of capital for banks and commercial actors in non-compliant states, creating new allies for policy change and incentivizing governments to improve compliance.

This argument suggests three broad theoretical propositions. First, IO monitoring that damages a country’s reputation without changing the behavior of non-state actors will have a weak impact on state policy. With the rare exception, states are unlikely to significantly modify bilateral relations in response to new information. Non-state actors, on the other hand, can levy penalties against non-compliant states but only if information about state behavior is relevant to their priorities. Second, across issue areas, when IOs can target information toward market actors that are willing to act as enforcers, monitoring is more likely to lead to significant policy change. As government regulation changes and shareholder priorities shift, IOs may find it easier or harder to identify potential market enforcers. Finally, the ability of IO monitoring to generate policy change via market enforcement will increase when (1) market actors find it easier to substitute investment decisions across countries; (2) IOs provide higher quality information, especially in comparison to markets; and (3) market actors are punished for not allocating resources properly.

2.5 Empirical Expectations

The FATF non-complier list is a strong case to test a theory linking information, reputation, and compliance. The FATF is a credible institution, with a long history of monitoring and disseminating information in a variety of forms. As a highly technical intergovernmental body, the FATF has set standards on combating money laundering and terrorist financing and monitored compliance through peer assessments since its inception in 1989. Over the course of its history, the FATF has twice use a blacklist-style format to identify publicly non-compliant countries and incentivize policy change. While the first list was directly tied to the coercive threat of sanctions, the most recent list (the non-complier list) has been largely
removed from proscribed financial consequences. Nonetheless, market actors like banks and international investors have profit-based incentives to care about whether they are sending money to countries that pose a high risk of money laundering or terrorist financing. For this reason, the FATF non-complier list changes how market actors allocate resources to non-compliant states.\textsuperscript{26}

Although the FATF evaluates compliance across many different recommendations, I focus on one of its most important recommendations: the criminalization of terrorist financing. The FATF considers the criminalization of terrorist financing to be a top priority and one of the six building blocks of the financial integrity regime (Interview of FSRB official, 27 January 2015). Compliance with this recommendation is also a clear indication of policy change. The FATF did not adopt the criminalization of terrorist financing as a recommendation until 2001, and prior to that time, only a handful of states had laws criminalizing terrorist financing.\textsuperscript{27}

The FATF requirement to criminalize terrorist financing is broad and far-reaching. States must criminalize terrorist financing beyond what is required in the Convention on the Suppression of the Financing of Terrorism. Specifically, governments must extend the terrorist financing offense to any person who provides or collects funds with the intention that they be used to carry out a terrorist act, by a terrorist organization, or by an individual terrorist. Laws must define “funds” as including assets of any kind from both legitimate and illegitimate sources. Moreover, per FATF guidelines, laws should stipulate that funds provided to terrorists do not actually have to be linked to any specific terrorist act.

If my theory is correct, it has several observable implications for how the FATF non-complier list affects markets and state policy on terrorist financing. First, when the FATF places countries on the non-complier list, we should observe a punitive market reaction.

\textsuperscript{26}Chapter 3 provides more detailed information about FATF monitoring and why market actors are interested in such reports.

\textsuperscript{27}This variable is, at best, a partial measure of compliance; legal and institutional changes cannot address whether countries are actually implementing key policies, as is clearly demonstrated by Findley, Nielson and Sharman (2014).
Second, the FATF list should be effective at incentivizing a wide variety of countries to criminalize terrorist financing in line with FATF standards. Third, the FATF list should have the strongest impact on listed countries that are highly integrated into international markets. I develop each of these hypotheses in more detail below.

2.5.1 Hypothesis 1: Listing and Market Punishment

Banks, companies, and investors are appraised based on profit margins; these powerful market players are most likely to care about a country’s money laundering or terrorist financing risk if it has the potential to impact corporate bottom lines. The relationship between these risk factors and profit margins, however, is a bit unclear. Historically, many market actors have done business with low financial regulation countries because such countries are often a destination for wealthy individuals seeking to avoid paying taxes. In the current era of high government regulation and scrutiny, however, financial institutions face competing incentives. “Customer due diligence” laws around the world require banks to design and implement systems that consider a customer’s risk of money laundering or terrorist financing. Banks and investors alike also have to worry about the potential damage to their reputations if they are caught doing business with criminals or terrorists.

FATF customer due diligence requirements apply to all financial institutions; however, banks are the most likely market actor to engage in market enforcement because they have the strongest regulatory and reputational incentives to increase the costs of capital for high-risk countries. Banks could manage risk in a variety of ways, by terminating partner relationships with other banks abroad (known as “correspondent banking” relationships), charging

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28The FATF defines “financial institutions” as including private banking, consumer or mortgage credit agencies, and organizations that engage in financial leasing, or issuing or managing means of payment. The category also includes institutions that trade in money market instruments, foreign exchange, index instruments, transferable securities, or commodity futures, as well as individuals and institutions that manage portfolios, underwrite life insurance, or change currency. (FATF-GAFI 2012).

29The majority of US government enforcement action has targeted banks.
higher interest rates to customers in certain countries, or subjecting high-risk customers to greater scrutiny.

Unlike banks, investors have no specific regulatory or reputational reasons to care about a country’s money laundering or terrorist financing risk. They are interested, however, in any information that might indicate that a government is less likely to repay its debt. Investors face significant uncertainty over sovereign debt because contracts are unenforceable and governments technically can always print more money if they need to repay borrowers (Abdelal and Blyth, 2015). For this reason, investors should be responsive to any type of information that might reveal a country’s ability or willingness to repay borrowers, and or that might shed light on how other investors are likely to judge a particular investment prospect.

The FATF non-complier list fulfills both criteria. The FATF’s monitoring process provides ample time for country input and technical assistance; as a result, governments have the opportunity to adopt the necessary rules and regulations to prevent listing and its concomitant reputational consequences. When governments fail to take such steps, it is a clear signal for market actors about the government’s capacity, political priorities, and its concern for maintaining a positive financial reputation. Listing also reduces uncertainty about how other investors are likely to evaluate a particular government, thus coordinating expectations across actors.

- **Hypothesis 1**: When the FATF includes countries on the non-complier list, banks and investors should take actions to mitigate country risk by decreasing financial flows or charging higher premiums for capital from these countries.
2.5.2 Hypothesis 2: Listing and Policy Change

When a credible and legitimate IO like the FATF releases public information indicating that certain countries are not in compliance with international standards, this type of institutional monitoring should damage the reputations of listed countries. If IO monitoring is disseminated in a format like a blacklist that clearly signals non-compliance, the reputational consequences of listing should be intensified. Under such conditions, listed countries should be increasingly likely to change their policies to comply with FATF standards.

There are many ways that the FATF’s effect on domestic policies might be observed. Countries might be more likely to adopt new legislation in the run-up to FATF plenary sessions. Leaders might also justify new legislation with reference to the FATF, or include references to the FATF in administrative orders issued to the bureaucracy. At a minimum, if the FATF list generates improved compliance, listed countries should pass laws that conform more closely to FATF standards more quickly than their non-listed counterparts.

- **Hypothesis 2:** When the FATF includes countries on the non-complier list, these countries should be more likely to adopt FATF-compliant laws on terrorist financing than non-listed countries, and policymakers should tie the passage of new legislation to the FATF.

2.5.3 Hypothesis 3. Market Integration and Policy Change

Listing is likely to have the strongest effect on countries that are highly integrated into international markets. When bankers integrate listing into their risk models and subject customers to extra scrutiny, or when investors charge higher premiums for debt from listed countries, these actions will directly affect the interests of certain domestic constituencies, specifically local financial actors. If banks find that it takes them longer to access international financial markets or send money overseas, they are likely to advocate rapidly for
governments to change their policies. Similarly, a central bank that is facing the prospect of a higher rate for new bond issue is likely to pressure the government to improve its international reputation. In both of these scenarios, the existence of market enforcement creates unexpected pro-compliance domestic allies, who will be influential in pressuring governments to change their policies.

- **Hypothesis 3**: The FATF non-complier list should be more likely to lead to the adoption of FATF-compliant laws on terrorist financing among listed countries with high levels of market integration.

### 2.6 Addressing the Alternative: The Role of US Power

By far, the most plausible alternative explanation is the possibility that the United States is directly or indirectly responsible for policy change in this issue area. Since the creation of the FATF, the United States has been the global leader on financial integrity, working to keep “bad money” out of the international financial system. The United States was the first country to criminalize money laundering (Peinhardt and Sandler [2015]) and one of the first countries to criminalize terrorist financing. Scholars have also argued that US economic power has contributed to the diffusion of US regulatory standards in other areas of global finance (Simmons [2001], Drezner [2007], Posner [2009]). At a minimum, the US government devotes significant resources to providing technical assistance that promotes the worldwide adoption of financial integrity standards[^30] it also monitors other countries’ policies[^31].

[^30]: For example, the US Department of Treasury’s Office of Technical Assistance has close to 100 projects that are designed to develop strong financial sectors across various issue areas, including tax administration, budget execution, debt management, financial sector supervision, and anti-corruption. For more information, see [https://www.treasury.gov/about/organizational-structure/offices/Pages/Technical-Assistance-.aspx](https://www.treasury.gov/about/organizational-structure/offices/Pages/Technical-Assistance-.aspx).

[^31]: The US Department of State publishes its findings in its annual International Narcotics Control Strategy Report, which summarizes money laundering and terrorist financing problems by country. This report even
The United States could drive policy change on terrorist financing in several ways. The US government might provide bilateral technical assistance or apply pressure on states through diplomatic channels. Alternatively, the US might threaten economic sanctions against countries that fail to criminalize terrorist financing. Finally, the US government might act as a de facto enforcer for the FATF. I discuss each of these explanations in turn and provide concrete evidence as to why they cannot explain policy change on terrorist financing in this period. Additional evidence is provided in chapter 5.

2.6.1 US Assistance and Bilateral Pressure

The United States could drive policy change on terrorist financing by providing technical assistance or pressuring countries bilaterally to change their laws. The US Departments of State and Treasury operate several programs that are designed to help other governments build the legal and administrative capacity to combat terrorist financing. Additionally, the US military and intelligence community work with allies to share information about counter-terrorism and provide operational assistance. The US government might also bolster international counter-terrorism efforts through international organizations like the UN Security Council or the UN Office on Drugs and Crime (UNODC), both of which work to build domestic capacity on these issues.

In addition to technical assistance, the United States might also bilaterally pressure countries to comply with FATF standards. Since the 9/11 attacks, the US government has considered the global war on terrorism to be a top security priority. Given this prioritization, US government officials are likely to advocate for stronger counter-terrorism laws and policy

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32 The US intelligence community spends about 16 billion US dollars annually on counter-terrorism efforts (Center 2013).

33 A UNODC official reported that donor countries often provide financial assistance for targeted capacity-building efforts in specific countries that pose a high risk of international terrorism (Author Interview, 7 May 2014).
in meetings with foreign countries. Such efforts are particularly likely to succeed with US allies, since the United States already has close security ties with such countries.

While US government technical assistance and bilateral pressure have undoubtedly contributed to policy change in this issue area, such explanations cannot account for the time trend in cooperative outcomes. While many countries adopted laws on terrorist financing in the years following 9/11, as of 2009, only about 10 percent of countries had FATF-compliant laws on terrorist financing. Indeed, significant improvements in compliance did not occur until the FATF adopted new procedures for its non-complier list and began listing countries. In contrast, US government support for counter-terrorism capacity building increased immediately after the 9/11 attacks. In 2000, for example, the US State Department’s budget for nonproliferation, anti-terrorism, de-mining, and related programs was $216 million; by 2009, the budget had more than doubled to an estimated $525 million. Since 2009, however, the State Department’s spending in this area has increased much more slowly.

Bilateral pressure also seems unlikely to explain this trend. During the early 2000s, the Bush administration took a fairly coercive approach to global counter-terrorism efforts, pressuring allies on this issue. In contrast, the Obama administration adopted a more conciliatory and cooperative tone toward US allies. Empirical evidence also suggests bilateral pressure is inadequate to explain this trend. In Chapter 5, I use the US State Department’s annual list of jurisdictions of primary money laundering concern as a proxy for US bilateral pressure. Regression analyses provide no support for this alternative explanation.

34 These numbers are drawn from the State Department’s annual Congressional Budget Justifications for Foreign Operations.
35 As of 2014, the State Department’s budget for these programs was $630 million. For more details, see https://www.state.gov/documents/organization/236395.pdf.
36 “Jurisdictions of Primary Concern” are major money laundering countries where financial institutions “engage in transactions involving significant amounts of proceeds from all serious crimes” or where financial institutions are vulnerable because of weak supervisory or enforcement regimes. For more on this definition, see: https://www.state.gov/j/inl/rls/nrcrpt/2016/vol2/253367.htm.
2.6.2 US Economic Sanctions

The United States might also use economic statecraft to coerce states into changing their laws. The US government might link foreign or military aid to policy change on terrorist financing, or threaten to levy economic sanctions against states that fail to meet FATF standards. If the US government takes some type of punitive action against countries that are on the FATF non-complier list, then US government action rather than FATF listing might be driving policy decisions. The most likely way that this would occur would be through the US Treasury Department’s sanctioning process. The US Treasury Department issues a “311 Special Measures” list of jurisdictions and financial institutions of money laundering concern. Under the Bank Secrecy Act, US financial institutions and agencies are required to take special measures against such designated entities. Special measures include additional record keeping requirements, steps to determine account ownership, and customer identification measures. In some cases, financial institutions may be prohibited from forming any type of banking relationship with financial institutions or countries on the 311 list.\footnote{For more on these requirements, see https://www.ffiec.gov/bsa_aml_infobase/pages_manual/OLM_031.htm.}

The US Treasury’s 311 list can inflict significant damage on listed entities and has been known to drive significant policy change. The US government first used its 311 powers in December 2002, in response to a call by the FATF to impose “countermeasures” on Nauru. Within days, offshore banks registered in Nauru began to close and the Nauruan government adopted new legislation to address its shortcomings (Zarate 2013, 153). Almost a year later, the US government designated the Myanmar government and two of its banks that were involved in drug trafficking. Although the Myanmar government responded by publicly criticizing the US action, it revoked the operating licenses of the two banks and soon after announced new money laundering rules to address US concerns (Zarate 2013, 155). To date, the US Treasury has listed 20 banks and 5 countries under the 311 process, and in several cases, the listing has driven significant policy change.
While the US Treasury’s 311 list has clearly incentivized states to improve financial integrity laws, it also fails to explain the significant policy change on terrorist financing. Between 2010 and 2016, the FATF included 57 countries on its non-complier list. Only two of these countries – Iran and North Korea – were on the Treasury Department’s 311 list at the same time. While the Treasury 311 list does include several banks from listed countries like Myanmar and Syria, the vast majority of FATF non-complier list countries have no connection to the Treasury 311 list. I test this mechanism directly in Chapter 5, finding no evidence that the US Treasury’s 311 list weakens the effect of the FATF non-complier list on policy change.

2.6.3 The Shadow of US Enforcement

An alternative possibility is that the FATF non-complier list is effective because it operates in the “shadow” of US power. Market actors might reallocate resources away from listed countries because they believe the list signals the possibility of subsequent US enforcement action. If, for example, market actors believe that the US government is likely to include FATF non-complier list countries on one of its sanctions lists, they might preemptively move resources away to avoid financial costs. This preemptive punishment process would create similar observable implications – market enforcement and policy change – but for different reasons. Instead of the FATF non-complier list signaling information about a country’s risk environment, it would signal an increased probability of US government enforcement.

Empirically, there is little evidence to support the notion that market actors view the FATF non-complier list as a signal of future US government enforcement action. With the exception of Iran, the US government has never added a government or bank in an FATF non-complier list country to its 311 list or imposed unilateral or targeted sanctions on a listed country. Even when FATF non-complier list countries were extremely slow to change

\[\text{38} \text{Banks in Myanmar and Syria were already on the 311 list at the time that the FATF listed these countries.}\]
their policies, as in countries like Angola and Indonesia, the US government never listed these countries unilaterally. Moreover, qualitative evidence provides no support for this mechanism.\footnote{Over the course of this project, I conducted close to 30 interviews with banking officials, investors, government officials, and bureaucrats from international organizations. None of those interviews provide evidence for this mechanism.}

A final possibility is that the FATF non-complier list matters solely because banks and investors are worried about the possibility of punishment from US regulators. US regulators clearly view the non-complier list as providing credible information about high-risk countries. If market actors believe US regulators will punish them for failing to integrate this information into compliance practices, market actors may be incentivized to engage in market enforcement. While this type of indirect effect would not undermine the larger theory, it would suggest an additional causal mechanism and a possible scope condition for market enforcement.

US government enforcement action undoubtedly influences bank incentives, but prospective punishment cannot fully explain the non-complier list’s effect on outcomes. As is discussed in greater detail in Chapter 3, US government regulation requires banks to evaluate customer risk based in part on geography. Per government guidelines, banks assess country risk on at least eight different factors – only one of which is the FATF non-complier list. While the US government follows up by enforcing regulation and fining violators, such enforcement has occurred since at least the early 2000s. Moreover, specific enforcement actions rarely highlight a failure to integrate information from the non-complier list into risk management processes. For example, when the US government fined HSBC 1.9 billion US dollars for money laundering violations in 2012, the US Senate’s 339-page report did not discuss a single instance where HSBC failed to adjust its risk appraisal of a country based on the non-complier list (Permanent Subcommittee on Investigations, 2012). Furthermore, interviews suggest large banks frequently go beyond what is required by regulators in terms
of managing risk. While US government action shapes bank and investor priorities, banks and investors themselves decide when to use the non-complier list as a key input into risk models.

2.7 Conclusion: IO Monitoring, Market Movements, and Compliance

Most international institutions lack formal enforcement power. However, in the current globalized era where financial flows connect countries around the world and information is its own currency, international institutions may be able to use monitoring and assessment to enhance institutional power. This chapter lays out a theory where international institutions, because of their credibility and legitimacy, can use IO monitoring to outsource enforcement to market actors. As powerful market players like banks and investors move resources away from non-compliant states, this process intensifies incentives for governments to change their policies. I use this theory to develop observable implications for my analysis of how the FATF non-complier list has affected market flows and policies in listed countries.

The next four chapters provide background on the case and test these observable implications through quantitative analysis and process tracing. Chapter 3 discusses the history of the FATF and the origins of the non-complier list, highlighting how the FATF adopted clear bureaucratic procedures for listing to increase the legitimacy of its efforts. Chapter 4 tests hypothesis 1, analyzing the impact of the non-complier list on markets. I demonstrate that investors and banks view listed countries as riskier investments and reallocate resources accordingly. Chapter 5 tests hypothesis 2 and shows that on average, the non-complier list has shortened the time it takes for governments to adopt comprehensive laws on terrorist financing. This chapter also considers the evidence for a US role in driving policy change. While US government regulation and enforcement certainly increased bank demand for infor-
mation about financial integrity risks, I find no evidence that US coercive power via bilateral pressure or sanctions is responsible for policy change. Finally, Chapter 6 tests the market integration hypothesis by analyzing the interaction of listing and market integration, and details the causal process leading from listing to policy change in a case study of Thailand.
Chapter 3

The FATF and the Fight Against “Bad Money”

This problem, it’s like the Dengue Fever. To fight the Dengue, you want the mosquito not to reproduce so you take the water out of vases. If you do this in a house, but if your neighbor doesn’t do it, the mosquito may still bite you. So you want your neighbor to also take care of it. AML/CFT is the same. If everyone works, you have a clean financial system. If not, everyone is contaminated.

Former FATF President Antonio Gustavo Rodrigues

The campaign to stop “bad money” from passing through the financial system is inherently global in nature. Efforts to protect the integrity of the financial system only work if countries around the world adopt and enforce similar laws Without legal harmonization, criminals simply move money from one jurisdiction to another, shopping around for the least regulation or enforcement. And such money transfers can have dire consequences. The 9/11 hijackers used US and foreign financial institutions to move approximately 300,000 US dollars through the financial system. This money paid for flight training, travel, and living

1Author interview, 29 March 2017. AML/CFT stands for “anti-money laundering/combating the financing of terrorism.”
2Throughout this dissertation, I refer to efforts to keep funds that are tied to criminals or terrorists out of the formal financial system as “financial integrity efforts.”
expenses (Roth, Greenburg and Wille 2004). At the time, the United States and most other countries in the world did not have laws criminalizing terrorist financing. Even with advance warning, there were no controls in place that could have detected or disrupted the hijackers’ transactions (Roth, Greenburg and Wille 2004).

This chapter provides background on how the international community works together to keep criminals and terrorists from accessing the international financial system. It begins by discussing the problem of financial integrity, and explains why it is so challenging for countries to prevent money laundering and terrorist financing. I then narrow the focus to international cooperation on combating terrorist financing. Since the 9/11 attacks, international counter-terrorism cooperation has expanded significantly. The cornerstone of such efforts has been the campaign to combat terrorist financing. Because funds are fungible and can be easily moved across borders, stopping terrorist financing requires widespread cooperation across states. Non-compliance by even a handful of countries can significantly worsen outcomes. Given such externalities, states have worked through international organizations (IOs) like the UN Security Council to incentivize more stringent laws on terrorist financing. Surprisingly, the institution that has had the strongest effect on cooperation is an informal intergovernmental body – the Financial Action Task Force (FATF).

The FATF is an international standard setter and compliance monitor that works to protect the integrity of global finance. Created by the G-7 countries3 the European Commission, and eight other states4 in 1989 in response to growing concern over money laundering, the FATF expanded its mission in 2001 to include combating terrorist financing. The FATF has no standing charter and no official legal authority over its members. It also issues recommendations rather than rules. Despite this weak institutional design, the FATF has become the premiere technical body on financial integrity through its monitoring and evaluation process.

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3Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
4Australia, Austria, Belgium, Italy, Luxembourg, Netherlands, Spain, and Switzerland.
Section 3 of this chapter provides additional background on the creation of the FATF and its evolution as an institution. Section 4 zeroes in on the FATF’s process for dealing with non-compliant jurisdictions. Between 2000 and 2006, the FATF used a list of non-cooperative countries to shame and coerce non-FATF countries to change their laws. Many countries viewed the process as illegitimate. The FATF attempted to address such critiques when it designed the procedures for its current non-complier list, which started in February 2010. Section 5 concludes by laying out my empirical strategy for examining the effect of non-complier list on markets and policy change.

3.1 The Challenge of Financial Integrity

While criminals have used the financial system to store and transfer money for hundreds of years, the fight to preserve the integrity of the financial system is relatively new. The United States was the first country to criminalize money laundering in 1986, with many European countries adopting similar laws in the 1990s. The effort to criminalize terrorist financing came even later, and it was not until the mid-2000s that financial integrity efforts expanded to include combating proliferation financing as well. The fact that a robust international regime exists today reflects the degree to which policymakers have prioritized international cooperation in this issue area over the last thirty years.

In some ways, money laundering and terrorist financing are an unusual pairing because they reflect opposite motivations and perpetrators. Many criminals commit crimes for the purpose of profit and need a way to “clean” the money so that they can use it without drawing the attention of law enforcement. Money laundering is the process by which criminals attempt to disguise the illicit origins of funds. Terrorist financing, in contrast, usually occurs when legally-acquired, non-illicit money is used to finance terrorist acts, individuals,

\(^5\) A wide variety of crimes fit into this category, including illegal arms sales, smuggling, drug trafficking, prostitution rings, embezzlement, insider trading, bribery, and computer fraud. For more on money laundering, see: [http://www.fatf-gafi.org/faq/moneylaundering/](http://www.fatf-gafi.org/faq/moneylaundering/)
or organizations. In money laundering terminology, terrorist financing occurs when “clean” money becomes “dirty.” Despite these differences, policymakers have linked money laundering and terrorist financing because both crimes affect the financial sector in similar ways. Both money launderers and financiers of terrorism might break up large amounts of money into smaller deposits to avoid suspicion. Similarly, both sets of actors might try to disguise the origins of money by wiring them through a series of accounts all over the world. As a result, if governments want to combat money laundering or terrorist financing, they need active cooperation from their own financial sectors, as well as the financial sectors of other countries.

While policymakers have clearly linked money laundering and terrorist financing, this research project focuses specifically on international cooperation on terrorist financing. There are several unique aspects of cooperation in this issue area that make it distinct from money laundering. First, because terrorist networks differ substantially in size, scope, and motivation, the crime of terrorist financing is quite varied. Second, international cooperation on terrorist financing sits within the larger counter-terrorism regime complex, which has grown substantially over the last twenty years. Finally, proposed terrorism legislation often leads to domestic debates about the balance between security and human rights; as a result, regulations to combat terrorist financing are often quite controversial. Each of these points is developed in greater detail below.

### 3.1.1 Terrorist Financing

Individual terrorists and terrorist organizations need funds for two reasons. First, a small portion of funds are used to fund direct operations and attacks. Terrorists may purchase vehicles or bomb-making components, or pay for travel to attack sites. An organization may also pay salaries to individual operatives or compensation to the families of martyrs, or it may fund training for specific missions. In most cases, however, the actual cost of a terrorist
attack tends to be quite low relative to its impact. Al-Qaida’s 1998 truck bombings of the US embassies in Kenya and Tanzania are estimated to have cost less than 50,000 US dollars, while the attack in 2000 on the *USS Cole* cost less than 10,000 US dollars ([United Nations Security Council, 2004](https://www.un.org)). Instead, the majority of terrorist financing is directed at broader organizational requirements. Terrorist organizations use funds to recruit members, provide charitable services to targeted populations, and conduct propaganda through media outlets ([FATF-GAFI, 2008a](https://www.fatf-gafi.org)).

Terrorists raise money from both legitimate and illicit sources. Individuals and terrorist organizations may solicit donations from businesses, charitable organizations, or wealthy individuals. Alternatively, terrorist organizations may use criminal activities like selling narcotics, credit card fraud, and extortion to fund their operations ([United Nations Security Council, 2004](https://www.un.org)). Historically, many terrorists were state-funded, as governments sought to use proxies to destabilize their neighbors and fight ideological battles; however, today, most terrorist groups operate without significant support from governments ([Pillar, 2012](https://www.fatf-gafi.org)).

Once terrorists acquire funds, they move money through the global economy in several ways. The fastest and most efficient way to move funds across borders is through the formal financial sector. Such actions may include bank-to-bank transfers, ATM deposits and withdrawals, or small-scale alternative remittance systems. There is some evidence that terrorists may also use the international trade system to transfer value and goods; an FATF case study of the trade sector indicates individuals and companies active in the diamond trade may have purchased and smuggled diamonds into Belgium for the benefit of a terrorist organization ([FATF-GAFI, 2008a](https://www.fatf-gafi.org), 23). Terrorists may also choose to operate outside of the financial sector entirely, using cash couriers to move funds or high-value commodities such as gold or precious stones. Although terrorists opt to use different financial pathways depending on the structure of their organizations and the nature of funds, terrorist organizations have also shown significant adaptability in how they finance their operations ([FATF-GAFI, 2008a](https://www.fatf-gafi.org)).
As a result, efforts to clamp down on financing in one form may lead to an increase in the use of alternative pathways.

3.1.2 The Counter-Terrorism Regime Complex

International cooperation on combating terrorist financing is a key component of a much larger global effort to fight transnational terrorism. This effort has evolved significantly in the years since the 9/11 attacks. Prior to this time, multilateral cooperation on counter-terrorism occurred primarily through a series of international conventions focused on preventing specific terrorist acts, including hijackings and the theft of nuclear material. This piecemeal approach reflected the cross-cutting nature of counter-terrorism, which often overlaps with other issue areas, and also the fundamental lack of agreement among states over the definition of terrorism. After the 9/11 terrorist attacks, however, states sidelined disagreements in favor of expanding cooperation, particularly on the issue of terrorist financing. The UN Security Council passed resolution 1373, which requires that all UN member states criminalize terrorist financing (Resolution 1373, 2001). Around the same time, the United States added the names of close to 100 suspected terrorists to a UN Security Council sanctions list that targeted individuals and entities affiliated with Al-Qaida and the Taliban (Interview of UN Security Council official, 15 March 2012).

To complement UN-centric efforts, states also began to reorient the focus of many issue-specific, technical institutions. In October 2001, the FATF expanded its anti-money laundering mission, issuing special recommendations on how states should combat the financing of terrorism. In 2002, the International Maritime Organization adopted new regulations to secure international shipping and ports from terrorist threats. The International Civil Aviation Organization, INTERPOL, the International Atomic Energy Agency, and the World Customs Organization also increasingly focused on terrorism, as did many regional organizations.
Today, international cooperation on counter-terrorism is characterized by a regime complex of partially overlapping, non-hierarchical institutions (Raustiala and Victor 2004). This regime complex is large and fragmented, and includes at least sixteen international conventions, thirty UN agencies, and a large network of regional and functional institutions (Millar 2010). The cornerstone of this effort is international cooperation on combating terrorist financing. Although states negotiated a treaty on the suppression of terrorist financing prior to 9/11, and although the UN Security Council was the first institution to act immediately after the attacks, the FATF has become the central actor on this issue. The FATF issues detailed recommendations on how states should combat terrorist financing, monitors the implementation of its recommendations, and publicly shames states that fail to comply. The UN Security Council has even obligated its members to follow the FATF’s recommendations, further legitimizing the FATF’s role as the premiere body in this issue area (Pratt 2017).

3.1.3 Political Stakes

Since 2001, most countries in the world have passed legislation to criminalize terrorist financing. Despite widespread support for fighting terrorism, many of these laws have been extremely controversial. There are two primary reasons for domestic pushback, both of which reflect the larger political context that surrounds counter-terrorism legislation. First, policymakers often choose to criminalize terrorist financing as part of a broader counter-terrorism law, which generates debates about the line between security and civil liberties. Such debates may even occur in the case of narrow terrorist financing legislation, depending on how a law defines the crime of terrorism. Second, in many cases, legislators have used counter-terrorism legislation for broader political purposes, such as expanding the powers of the executive or clamping down on minority rights. Each of these points is developed below.

In the aftermath of 9/11, many countries adopted counter-terrorism legislation that infringed on civil liberties. The United Kingdom’s expansive anti-terrorism law is perhaps
the best example of this overreach. The Anti-Terrorism, Crime and Security Act, passed in December 2001, included a wide range of measures, most notably the power to freeze terrorist funds without legal proceedings and the power to detain suspected international terrorists indefinitely without charge. To pass the bill, the UK Home Secretary declared a state of public emergency, which allowed the government to derogate from its obligations under the European Convention on Human Rights (Nicholls 2002). Although the bill was defeated seven times in the House of Lords, it was eventually pushed through with minor modifications, leading UK newspaper The Independent to declare it “improved by the compromises agreed at the last minute, but... a deeply offensive, illiberal and unnecessary set of measures” (This weekend, Britain is a less free country. And to what purpose?, 2001).

Similar conflicts between counter-terrorism policy and civil liberties took place all over the world. In the Philippines, President Gloria Arroyo repeatedly called for strong anti-terrorism legislation, but the proposed bills were blocked by pushback from the opposition party, civil liberties groups, and the media. Legislation was finally passed in March 2007 after nearly four years of debate and significant concessions (Whitaker 2007). A much more prolonged process played out in South Korea, which drafted counterterrorism legislation immediately after the 9/11 attacks. Opposition forces agreed with the general mission, but opposed the government’s effort to give expansive new powers to the National Intelligence Service (Asmolov 2015). The government struggled to push the legislation through the National Assembly for 15 years. Over significant opposition, the bill was finally passed in March 2016 in response to a recent nuclear test and rocket launch by North Korea.

Governments have also used counter-terrorism legislation to advance their own political agendas. In response to a December 2001 terrorist attack on its parliament, India passed the Prevention of Terrorism Act in March 2002, granting its government broad powers to fight terrorism. The Act was used as a way to target minorities and political opponents, and included an overly-broad definition of terrorism that enabled the government to detain
suspects for months without charges (Guiora 2006). In Kenya, proposed anti-terrorism legislation generated strong criticism from human rights advocates and religious leaders, particularly Muslims who felt especially targeted by the bill (Whitaker 2007). In Turkey, opposition leaders blocked new terrorism legislation for several years over concerns that it would be used to wrongly label people as terrorists (Ozbilgin and Burch 2013).

Perhaps most notable is Brazil, which did not pass a law criminalizing terrorist financing until 2016. Brazil’s resistance to passing legislation was rooted in its authoritarian past, which left many citizens suspicious of laws that lack precise definitions of crimes (Roach 2015). Domestic debates were complicated by the former regime’s history of associating anti-government action with terrorism [6]. Despite these complex domestic factors, however, Brazil eventually passed counter-terrorism legislation in response to international pressure in the run-up to the 2016 Olympics. The final legislation was controversial, in part because it included a vague definition of terrorism that human rights groups suggested could be used against organized protests (Santoro 2016). Yet even in this context, international pressure eventually won out.

3.2 The Financial Action Task Force

The FATF sits at the heart of the global regime to combat terrorist financing. Although the organization started off as a small, club institution, it has since expanded into a broad global network that includes more than 190 countries. The FATF has two primary missions: standard setting and promoting the effective implementation of policies to protect the integrity of the financial system. Such policies typically target funds linked to money laundering, terrorist financing, or proliferation financing.

[6] Indeed, former Brazilian President Dilma Rousseff, who was elected in 2010, was tortured by the military as a terrorist in 1970.
3.2.1 From Small Club to Global Network

The FATF grew out of a concerted US effort to regulate money laundering internationally. Although the US Congress first criminalized money laundering in 1986, the US government soon found that domestic law was insufficient for controlling transactions in other countries. With the number of international transactions increasing exponentially, the United States needed a multilateral effort to comprehensively address the problem of money laundering. In 1988, the United States urged G-7 countries to take steps to prevent the use of banks for money laundering, and laid the groundwork for a future group or commission to tackle the issue (Kilborn, 1988). Jakobi (2015) argues the US government opted to seek G-7 support due to a lack of international alternatives and ongoing difficulties with bilateral law enforcement and mutual legal assistance treaties. The following year, the G-7 announced the formation of a financial action task force to assess ongoing efforts at combating money laundering and to consider additional preventive endeavors (G-7, 1989). The FATF held its first meeting a year later.

The FATF is an informal body – it has no standing charter or legal authority over its members. Instead, FATF members periodically review and renew its mandate. Member states renewed the initial five-year mandate in 1994, deciding that they would not make a final decision on the future of the FATF until the 1997-1998 period. The 1998 review led to another five-year mandate renewal and the expansion of the FATF’s mission to include “the establishment of a world-wide anti-money laundering network” through the creation of new FATF-style regional bodies and the expansion of the FATF membership (FATF-GAFI, 1998). By 2004, when the FATF renewed its mandate for eight years, FATF membership had increased to 33 members, and the Task Force had developed a network of five regional affiliate bodies in Asia, the Caribbean, Eastern Africa, Europe, and South America (FATF-GAFI, 2004). When the mandate was renewed for another eight years in 2012, the FATF had a broad network of affiliated regional organizations covering every major region in the
Figure 3.1: *FATF Members and Affiliates* - Countries in dark blue are current FATF members. Countries in light blue are non-FATF members of FATF-style regional bodies. Although many FATF member states are members of at least one regional body, this information is not shown on the map.

world. Today, the FATF has 35 member jurisdictions and nine associated regional bodies that assess compliance in more than 190 countries. Figure 3.1 shows the FATF’s global network.

Today’s FATF membership is a diverse array of states that reflects the organization’s Euro-centric founding and its efforts to expand to include “strategically important countries” (FATF-GAFI 1998). Table 3.1 shows how the FATF has expanded over time. It is notable that the more recent additions to the membership have all been economically and strategically important countries, which may increase the perceived legitimacy of the organization.

The majority of countries in the world participate in the global financial integrity regime through FATF-style regional bodies. These affiliate bodies are essential for several reasons. First, regional FATF affiliates promote and monitor the adoption of FATF standards among their members, relieving significant responsibility from the FATF’s small secretariat.\(^7\) Regional FATF affiliates work with the FATF and its members to clarify the recommendations

\(^7\)At the time that I met with FATF officials in 2014, the FATF Secretariat had a total of 16 people.
Table 3.1: *FATF Members Across Time* - The table shows the year that each member joined the FATF. Italicized members are regional organizations.

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<tr>
<th>Country</th>
<th>Year of Membership</th>
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<td>Malaysia</td>
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and provide advice on policy implementation; they also provide and facilitate the provision of technical assistance[^8]. These FATF affiliate organizations are also important, however, because they enhance the legitimacy of the FATF’s efforts. Once the FATF decided to expand its mission to include the dissemination of anti-money laundering policy worldwide, the FATF needed venues for this process. The FATF global network has socialized bureaucrats from countries around the globe into the anti-money laundering regime (Sharman, 2011).

[^8]: In some cases, FATF members are also members of FATF-style regional bodies. For example, Australia, Canada, China, Hong Kong, Malaysia, New Zealand, Singapore, and The United States are all members of the FATF and the Asia-Pacific Group, the FATF regional body for Asia.
The regional affiliate structure has allowed the FATF to expand its influence without expanding its membership, which might undermine its technical nature and ability to reach consensus. The hub-and-spokes system is clearly unequal – the FATF designs and interprets the rules, leaving FATF affiliate members no formal pathway to influence such outcomes – but for the most part, countries have been willing to accept this design, perhaps because there’s no other option. Former FATF President Antonio Gustavo Rodrigues acknowledged this inherent tension, pointing out that in theory, “everybody would want to be part of the FATF, but if everybody’s part of the FATF, it wouldn’t be the FATF, it would be the United Nations” (Interview by Author, 29 March 2017). The organization’s success as a technical body depends in part on its small membership; a larger organization might be more democratic, but would get much less done.

3.2.2 Mission 1: Standard Setting

One of the FATF’s two primary missions is to set global standards on how states should combat threats to the integrity of the financial system. At the time of the FATF’s creation, its standard-setting mandate primarily focused on anti-money laundering policies. In 1990, the FATF issued the “Forty Recommendations” on legal, regulatory, and operational measures that governments could take to prevent drug money from going through the financial system. The recommendations called on states to criminalize money laundering in specific ways, strengthen international cooperation, and provide legal assistance to other countries. Other recommendations focused on how governments should regulate the financial industry. Banks and other financial actors were supposed to keep records, verify customer identities, and establish their own programs against money laundering, including giving special attention to transactions with countries that do not follow the FATF standards [FATF-GAFI 1990].
In 1996, member states revised the recommendations to expand the scope of criminal activities, such that predicate offenses\footnote{Predicate offenses are the crimes committed as part of a bigger crime. In the case of money laundering, predicate offenses are usually crimes that lead to the acquisition of wealth, which is subsequently laundered through the financial system.} included crimes beyond narcotics trafficking. FATF members also agreed to make it mandatory for financial institutions to report suspicious transactions to authorities \cite{FATF-GAFI,1996}. Such changes were significant because they expanded the scope of obligations for financial institutions, creating more burdensome requirements. They also laid the groundwork for the FATF to deal with a wider range of issues beyond illicit drugs. The 40 Recommendations were subsequently updated again in June 2003.

The most significant change to the FATF’s mandate followed the 9/11 terrorist attacks, when the FATF expanded its mission to include combating terrorist financing. In October 2001, the FATF issued eight “Special Recommendations” on terrorist financing. These recommendations propose that states should take a wide range of actions, including the ratification and implementation of relevant UN conventions, the criminalization of terrorist financing, the freezing and seizure of terrorist assets, and the expansion of international assistance on this topic.\footnote{Additional actions include reporting suspicious transactions related to terrorism, imposing anti-money laundering requirements on remittance systems, strengthening customer identification measures, and ensuring non-profits cannot be misused to finance terrorism.} In 2004, the FATF added a ninth Special Recommendation focused on preventing the use of cash couriers to finance terrorism.

In 2011, the FATF conducted a comprehensive review of all the recommendations, soliciting engagement from FATF regional affiliates and other international organizations like the World Bank and the IMF, and also holding public consultations with the private sector and civil society \cite{FATF-GAFI,2011}. The updated recommendations, published in 2012, consolidated the 40 anti-money laundering recommendations and 9 combating terrorist financing recommendations into one list of 40 recommendations. As with its earlier efforts, the FATF also expanded the scope of its recommendations, this time to include proliferation...
financing. Over the last decade, the widening has continued, and today, the FATF’s list of illicit financial activities includes nuclear proliferation, corruption, transnational organized crime, and maritime piracy (Nance, 2015).

3.2.3 Mission 2: Monitoring and Assessment

The FATF’s second mission is to promote the implementation of its recommendations by monitoring and assessing the progress of its members. The FATF accomplishes this objective through its “mutual evaluation process,” which is a peer review monitoring process in which bureaucrats from peer countries work with the FATF Secretariat to assess other countries. Since its inception, the FATF has conducted three complete rounds of mutual evaluations, and is currently in the middle of its fourth round. Prior to each round, the FATF revises its recommendations and agrees on a methodology for evaluating compliance. Members then agree to a schedule for when each country will be evaluated, spacing evaluations out such that there are a limited number of countries evaluated each year. Because the evaluation process is lengthy and highly technical, each country is only evaluated once per cycle.

A typical mutual evaluation takes up to 18 months to complete. Before the assessment begins, the FATF organizes a training for bureaucrats from the assessed country to ensure that they understand the recommendations and what they will need to demonstrate during the evaluation process. The President of the FATF then selects a team of assessors from a pool of trained assessors, taking into account the requisite expertise for the evaluation.

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11 The FATF did not use a methodology for its first or second rounds of evaluations, but since 2004, it has employed this approach.
12 Although this section focuses exclusively on the FATF’s evaluation process, the evaluation process for FATF regional affiliates is very similar. FATF-style regional bodies use the same recommendations, assessment methodology, and procedures, and employ similar follow-up processes.
14 The FATF organizes regular training sessions to train bureaucrats from FATF member countries, FATF-style regional body member countries, and FATF observer organizations like the World Bank and the IMF, to understand the FATF recommendations and the assessment methodology.
uation, including language and background. According to the FATF, assessed countries do not have a say in the expert selection process.

During the process, the assessed country provides information to the assessment team about its laws and regulations. The team analyzes this information with reference to the FATF recommendations and produces a draft report, assessing the level of technical compliance for each of the recommendations. Countries are rated based on to what extent they meet the FATF’s “essential criteria,” which are laid out in the FATF’s interpretive notes on its recommendations. The compliance ratings are based on the following scale:15

- **Compliant** - The recommendation is fully observed. Country meets all essential criteria.
- **Largely Compliant** - There are minor shortcomings, but the large majority of essential criteria are met.
- **Partially Compliant** - Country has taken some substantive action, and complies with some essential criteria.
- **Non-Compliant** - There are major shortcomings, with a large majority of essential criteria not met.
- **Not Applicable** - A requirement or part of a requirement does not apply, due to the structural, legal, or institutional features of a country.16

The assessment team uses the information in the draft report to identify specific areas to focus on during the on-site visit. This “scoping note” might highlight country-specific threats or vulnerabilities, the type of economy, the size of the financial sector, political stability and commitment to rule of law, or the maturity of the country’s financial integrity system. Country officials have an opportunity to comment on the scoping note in advance of the on-site visit.

The assessment team then travels to a country for a two-week visit. During this time, they meet with government officials and the private sector to see how laws work in practice. In previous evaluation rounds, this visit was used to confirm or revise assessments of

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15 Descriptions based on rating scale laid out in FATF-GAFI (2009c, 6).
16 This category is rarely used.
technical compliance. In the current evaluation round, it is also used to assess the effectiveness of a country’s anti-money laundering and combating terrorist financing procedures. Immediately after the visit, the assessment team finalizes the mutual evaluation report and allows the assessed country to comment on the draft. A team of independent assessors also reviews the report, but the FATF evaluation team is the final authority on the report’s text and proposed ratings.

The FATF circulates the final report in advance of the next scheduled plenary session. During the plenary meeting, FATF members discuss the assessors’ findings and proposed ratings. The FATF makes decisions by consensus; therefore, to change a country’s rating, all FATF members (except for the assessed country) must agree to the change. Given the large number of recommendations and the high bar for changing a rating, countries in practice are able to advocate for at most one or two ratings upgrades. The FATF plenary then adopts the report.

How much influence do countries have over the contents of their reports? More capable and powerful governments will certainly devote resources to advocating for improvements in their ratings, but in general, such strategies are likely to change only a handful of ratings. A US government official acknowledged that countries advocate for better ratings during this process, but suggested such efforts have a limited impact on final outcomes. In her words, “It doesn’t matter how good your advocate is, because the assessors and experts will ask questions. It’s difficult to pull one over on FATF” (Author interview, 2 March 2015). Indeed, even the most powerful FATF members like the United States, the UK, Germany, and Japan received ratings of non-compliant on some of the recommendations.

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17 In the fourth round of evaluations, the FATF and the FATF regional affiliates are assessing both technical compliance with the 40 recommendations and the overall effectiveness of a country’s system with respect to eleven specific criteria.

18 This statement is based on the author’s observation of the Asia-Pacific Group 2016 plenary, as well as interviews with officials from the FATF and FATF-style regional bodies.

19 During the third round of evaluations, the US was rated non-compliant on 4 recommendations [FATF-GAFI, 2006], the UK was rated non-compliant on 3 recommendations [FATF-GAFI, 2007], Germany was
The limited ability of members to influence ratings occurs for several reasons. First, the reports evaluate compliance with 40 different FATF recommendations, and therefore, even if countries want to object during the drafting phase, they are usually forced to focus their objections on the ratings for a small number of recommendations. This is particularly true because the assessment team, not the country, makes the final determination as to whether it will change a country’s rating prior to the plenary session. Second, during the plenary session, FATF and regional affiliate body procedures dictate that there must be an “emerging consensus” to change a country’s rating. In practice, this means that to change a rating, many countries must support the evaluated country’s proposal and few countries must object. Given this high bar, most member states succeed in improving one or two ratings at most.\(^{20}\)

After the FATF plenary adopts the report, the FATF Secretariat circulates it to the 198 countries that belong to the FATF global network. Countries review the report for technical quality and consistency prior to the report’s publication on the FATF’s website. The final report will include not only ratings and in-depth analysis, but also recommendations for how the assessed country can strengthen its financial integrity system.

At the end of the monitoring process, the FATF places a country into one of several follow-up processes. Most countries are in the regular follow-up process, which requires them to report to the FATF after two and a half years about steps taken to remedy deficiencies identified in the mutual evaluation report. Alternatively, the FATF may place a country into an enhanced follow-up process, requiring it to report back to the FATF plenary within four plenary meetings of the report’s adoption, and to provide subsequent reports at steady intervals. Regardless of the follow-up process, the FATF conducts a 5-year follow-up assessment with the expectation that countries will have “addressed most if not all of the technical

\(^{20}\)This statement is based on conversations with FATF regional affiliate officials and the author’s participant observation at the APG Plenary Session in September 2016.
compliance deficiencies by the end of the 3rd year, and the effectiveness shortcomings by the
time of the follow-up assessment” (FATF-GAFI 2013, 20).

3.3 FATF Blacklisting

The FATF primarily motivates countries to implement money laundering and terrorist fi-
nancing counter-measures through its monitoring and evaluation process; however, since
2000, it has also used various forms of “blacklisting” to “name and shame” non-compliant states.\(^{21}\) The FATF’s initial effort – the Non-Cooperative Countries and Territories (NCCT) process – was focused exclusively on non-FATF members. Although it was successful at generating significant policy change, it was widely viewed as illegitimate and coercive. When the FATF designed its subsequent non-compliance process – the International Cooperation Review Group (ICRG) – member states took into consideration many of the earlier critiques. As a result, the ICRG process has managed to retain legitimacy while also being a successful tool for incentivizing policy change. Details on both processes are provided below.

3.3.1 Early Efforts: 2000 - 2009

In the late 1990s, FATF members decided that excessive banking secrecy and the use of shell companies in non-FATF countries were significant impediments to global anti-money laundering efforts. Inspired by the Organization for Economic Cooperation and Development’s (OECD) tax competition project, which publicly identified tax havens, FATF members began to formulate a similar program for money laundering (Gordon, 2010).\(^{22}\) The FATF established an \textit{ad hoc} group to define criteria for identifying non-cooperative countries and territories (FATF-GAFI 1999, 35); this group identified 25 criteria focusing on problems like

\(^{21}\)I use the colloquial term “blacklist” to describe any type of list of countries or actors that have failed to meet some established criteria.

\(^{22}\)The small FATF Secretariat is actually housed within the OECD, so it is not surprising that there would be some overlap in methodology across the two organizations.
inadequate supervision of the financial sector, weak customer identification requirements, and obstacles to international cooperation.\footnote{A full list of the NCCT criteria is available in the FATF’s First Report on Non-Cooperative Countries and Territories, published 14 February 2000, available at \url{www.fatf-gafi.org}.} Based on the criteria, the FATF reviewed 26 jurisdictions and publicly identified 15 countries as non-cooperative. This initial NCCT list included Israel, Lebanon, Liechtenstein, Panama, the Philippines, and Russia, as well as many smaller tax havens (FATF-GAFI 2000). In 2001, the FATF examined an additional 13 jurisdictions, adding 6 to the NCCT list.

The NCCT list was very successful at generating policy change, perhaps because it was accompanied by a coercive threat. The FATF called on financial institutions in member states to “give special attention to business relations and transactions with persons, including companies and financial institutions” from countries on the NCCT list (FATF-GAFI 2000, 12). It threatened additional counter-measures against countries that did not make enough progress\footnote{The FATF defines “counter-measures” to include enhanced surveillance and reporting of financial transactions, enhanced reporting on transactions involving the non-compliant country, and consideration of the country’s non-compliant status when establishing bank branches or subsidiaries (FATF-GAFI 2003).} and subsequently used such measures again Nauru in 2001 and Myanmar in 2003. Most countries quickly enacted the necessary legislation and were subsequently delisted\footnote{This statement is based on the author’s analysis of the FATF’s eight NCCT reports, published between 2000 and 2007. Reports available at: \url{http://www.fatf-gafi.org/}. Accessed on 17 April 2017.}

Gardner (2007) argues that the informality of the NCCT review process allowed the FATF to be more agile and flexible in how it responded to non-compliant countries. Although the FATF considered 25 separate criteria when making its NCCT decisions, there was no specific administrative cut point. Instead, the FATF considered the overall effect of a country’s laws in determining whether it should be listed. The downside of this approach, however, was that it was easily criticized “for being arbitrary and lacking a consistent methodology” (Tsingou 2010, 623)\footnote{At this time, the FATF did not have a detailed methodology for assessing compliance.} The list itself seemed highly politicized due to obvious omissions. The vast majority of offshore financial centers, for example, were not included on the list, reportedly...
due to efforts by the United Kingdom and Canada to protect territories with which they had close relationships (Gordon, 2010, 92).

Although the NCCT process did not formally end until 2006, the FATF stopped listing new countries in 2001. This halting of operations was due in large part to the significant opposition to the procedure. At the time, several key FATF members, including the United States, were pressuring the IMF and the World Bank to become involved with assessing compliance with FATF standards. The IMF and the World Bank were initially reluctant to expand their mandates, in part due to concerns about the NCCT process. Both institutions eventually agreed only after Germany, then the president of FATF, indicated that FATF had no plans to add more countries to the list. The IMF also insisted that FATF have a detailed methodology for assessing compliance with its recommendations, and produced a draft document with very detailed criteria that, according to an IMF staff member, would “make it very hard for the FATF to be easy on themselves and hard on others” (Gordon, 2010, 96). The FATF adopted a version of this methodology several years later, and used it for evaluating compliance during its third round of evaluations (2005 - 2014). The current round of mutual evaluations also relies on a strict methodology document.

As the FATF ended the NCCT process, it established the International Cooperation Review Group (ICRG) to analyze and publicly identify high-risk jurisdictions. The ICRG differed from the NCCT in several ways. Unlike the NCCT process, the ICRG was focused not just on money laundering risk but also on terrorist financing. According to former FATF President Antonio Gustavo Rodrigues, the FATF created the ICRG because, when the NCCT process ended, they wanted a way to pressure certain problematic countries to change their policies (Author interview, 29 March 2017). The initial ICRG process reflected this motivation – there were no established procedures for identifying states. Instead, FATF or FATF regional affiliate members could nominate countries for inclusion

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27 In 2006, the FATF removed the last country from the NCCT list.
Between 2008 and 2009, the FATF issued a series of statements highlighting money laundering and terrorist financing risks in six countries: Uzbekistan, Iran, Pakistan, Turkmenistan, Sao Tome and Principe, and northern Cyprus. For all countries except Iran, these announcements appear to have incentivized additional engagement with the FATF and relevant regional bodies; in some cases, countries even passed new legislation (FATF-GAFI, 2009a). The lack of ICRG procedures and the narrow scope of the process, however, limited its ability to bring about large-scale policy change.

3.3.2 The Revitalized ICRG and the Listing Threshold

The FATF began to revise its ICRG procedures in 2009, following calls by the G-20 to increasingly take action against non-compliant jurisdictions. In February 2009, the FATF held a preliminary discussion on possible revisions to the ICRG procedures for identifying non-compliant countries. A few months later, in May, the FATF agreed to create a “pool of jurisdictions” for initial ICRG consideration. This ICRG pool of jurisdictions could include any of the following:

1. **Nominated States**: Countries nominated by the FATF or FATF regional affiliate delegations on the basis of uncooperative behavior, non-compliance, or significant money laundering or terrorist financing risks.

2. **Non-Participants**: Countries that do not participate in FATF regional affiliates and the mutual evaluation process (including the follow-up process), or countries that do not agree to publish their reports.

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28This push was part of a broader G-20 strategy to respond to the global financial crisis. In April 2009, the G-20 issued a statement agreeing to “take action against non-cooperative jurisdictions, including tax havens. We stand ready to deploy sanctions to protect our public finances and financial systems. The era of banking secrecy is over.” (G-20, 2009).

29Based on FATF-GAFI (2009b).
3. **Non-Compliers:** Countries that receive failing ratings on 10 or more of the 16 most important FATF recommendations in their third-round mutual evaluation report.

The FATF’s new ICRG eligibility criteria combined old and new listing procedures. The first qualifying criteria – countries nominated for consideration by FATF members or FATF regional affiliates – was part of the original ICRG process. The second criteria was clearly designed to incentivize countries to actively participate in the FATF global network. In contrast, the third criteria was new and unprecedented, in that it significantly expanded the number of countries eligible for review. So how did the ICRG – and the FATF, which adopted the ICRG procedures – come to agree on this 10-failing-recommendation cut point?

The origins of this threshold go back to the FATF’s decision, sometime in 2008, to identify 16 of its 49 recommendations as the most important recommendations (referred to as the “key and core” recommendations). A few years into the third round of mutual evaluations, FATF members came to realize that many countries were overwhelmed by the quantity of recommendations and were struggling to prioritize different tasks. Member states also came to view certain recommendations as much more important than others. As a result, the FATF began an effort to identify the most core and fundamental recommendations, without which a country could not have a workable anti-money laundering system. Members eventually agreed on 16 recommendations. These recommendations include the criminalization of money laundering and terrorist financing, customer identification and record keeping, suspicious transaction reporting, international cooperation, asset freezes, financial supervision, and the maintenance of a functional financial intelligence unit [FATF-GAFI, 2009e].

When the ICRG began to draft procedures for its revised process, it used this list of the 16 most important recommendations to guide decision-making. The ICRG began by debating exactly how many recommendations a country needed to have in place to have a functioning anti-money laundering and combating terrorist financing regime. States participating in the ICRG working body eventually arrived at 10 as a workable threshold for non-compliance.
countries with 10 or more failing ratings (scores of non-compliant or partially compliant) should be eligible for ICRG consideration (Author interview of former FATF President Antonio Gustavo Rodrigues, 29 March 2017). According to an Executive Secretary of an FATF-style regional body who was involved in the design process, ICRG participants chose 10 because it represented “a preponderance of recommendations” (Author interview, 30 June 2016).

The ICRG’s decision to opt for a 10-failing-recommendation cut point, beyond which all countries would be eligible for listing, is significant for several reasons. First, it established very clear bureaucratic criteria for consideration – criteria that are based exclusively on the FATF’s recommendations. This direct link between the content of the recommendations and eligibility for listing enhances the legitimacy of the process, as does the fact that both FATF and FATF regional affiliate countries can fall above the threshold. The ICRG’s decision to use a 10-failing-recommendation was also significant because it creates a constantly renewing pool of eligible jurisdictions, some of which may even be FATF members. As of June 2009, when the ICRG adopted its new procedures, the FATF and the FATF regional affiliates had already evaluated 105 countries, more than half of which were suddenly eligible for inclusion on the list. Unlike the NCCT process, initial selection into the pool was clearly technical and unlikely to be politicized. At the time that these countries were evaluated, the FATF had not yet identified any priority recommendations or established a ten-failing-recommendation threshold; there was no reason for countries to work to improve their ratings on these specific recommendations.

The new ICRG procedures also enhanced the legitimacy of the listing process by incorporating input from non-FATF members. When a country is eligible for ICRG review, the ICRG assigns it to one of four regional review groups. All groups are co-chaired by a relevant FATF regional affiliate organization and an FATF member. The review group gathers information from the eligible country, analyzes content, and drafts a report for ICRG
consideration. This initial report makes a recommendation on listing, weighing factors like the country’s size and integration of the financial sector. The ICRG also considers a country’s risk of money laundering or terrorist financing, and its failure to criminalize money laundering or terrorist financing.

Based on the regional ICRG report, the ICRG recommends to the FATF whether there is a case for a full ICRG review. If the FATF authorizes a full review, the FATF President notifies the concerned jurisdiction. The relevant ICRG regional body then launches a more complete review process. The ICRG works with countries to craft proposed action plans to address identified anti-money laundering or combating terrorist financing deficiencies. Importantly, throughout this process, there is a looming threat of public shaming. The ICRG allows countries to demonstrate political will to address deficiencies and avoid listing, but as a result, if “at any time...the ICRG determines that the jurisdiction is not making sufficient progress, the ICRG could recommend that the jurisdiction should be publicly identified” (FATF-GAFI, 2009b, 12).

3.3.3 The Non-Complier List

The FATF issues new ICRG lists three time every year, following the FATF plenary sessions (February, June, October). These announcements, which I term “the non-complier list,” publicly identify countries with strategic anti-money laundering or combating terrorist financing deficiencies. In February 2010, when the FATF issued its first announcements under the new ICRG procedures, it identified 28 countries of concern. Over time, the list has expanded and to-date, the FATF has listed 61 countries under the ICRG process. Table 3.2 shows all countries listed under this process since its revitalization in 2010, along with

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30 Additional factors include not responding to requests for international assistance, the extent to which a country seeks and implements technical assistance, the degree to which a country demonstrates a willingness to address its anti-money laundering or terrorist financing deficiencies, and whether the country is already involved in a comprehensive follow-up process with the FATF or an FATF-style regional body (FATF-GAFI, 2009b).

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the date of listing and the date of graduation from listing (where relevant). The FATF has removed 47 countries from the list following significant policy change, which suggests the list has been an effective tool at driving legislative action. Removal from the list, however, does not preclude the possibility of re-listing.

The FATF non-complier list is actually composed of four separate-but-related lists. The FATF’s largest list is what is colloquially called the “grey list,” issued through an announcement titled “Improving Global AML/CFT Compliance: On-going Process.” This announcement identifies countries that have strategic deficiencies but have developed an action plan and provided a high-level written commitment to remediying the deficiencies. The FATF’s next highest level of listing is its “dark grey” list, which is issued through the same announcement but serves to warn countries publicly that if they do not make enough progress, they will face the possibility of enhanced due diligence from the financial sector.

The highest two FATF lists – the so-called “black list” and the “counter-measures” list – are issued through FATF Public Statements. In these public statements, the FATF identifies countries with strategic deficiencies and calls for possible financial repercussions. When countries are on the black list, the FATF calls on its members and other jurisdictions to “consider the risks arising from the deficiencies associated with each jurisdiction.” Finally, the counter-measures list calls on countries to apply counter-measures to protect the international financial system. Since the start of the ICRG process, the FATF has only ever included two countries on its counter-measures list: Iran and North Korea.

The four-tier listing system introduces a high level of differentiation into the non-complier list. By maintaining a list of cooperative countries working to address their deficiencies, the

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31 The FATF removed Sao Tome and Principe after deciding it was a low threat and no longer needed monitoring.

32 For example, Ethiopia was listed from 2010 to 2014 based on the results of its third round mutual evaluation report. In 2017, the FATF re-listed Ethiopia based on the results of its fourth round mutual evaluation report (FATF-GAFI, 2017).

33 Even when other states have had long-term strategic deficiencies, the FATF has never moved these countries up to the counter-measures list. Ecuador, for example, was on the non-complier list from February 2010 until July 2015, but was never put on the counter-measures list.
FATF has a lower threshold for listing than if the list exclusively targeted non-cooperative, high-risk jurisdictions. From a political standpoint, this may make the list more palatable for a wider set of states. During interviews, officials from financial intelligence units[^34] in several formerly listed countries were quick to point out that their countries were never on the “blacklist” (Author interview, 9 February 2016; Author interview, 14 February 2016). But the effect of the “grey list” cannot be disentangled from the other lists since even at this lowest level, countries that are part of the non-complier list are aware that if they do not make enough progress, the FATF may move them up to one of the higher lists. Indeed, a Citigroup official described the FATF’s lowest list as a “scare tactic” designed to put pressure on listed jurisdictions (Author interview, 28 August 2015).

3.4 Conclusion: Strengthening Financial Integrity Worldwide

Over the last 20 years, the international community has significantly expanded its efforts to keep criminals and terrorists from using the international financial system. International cooperation in this issue area is extremely challenging. Many countries lack the capacity or political will to adopt new laws or regulations, and non-compliance by a handful of states can create global vulnerabilities. Nonetheless, anti-money laundering and combating terrorist financing standards have diffused worldwide. The institution at the heart of this financial integrity effort is the FATF. The FATF is an informal club institution that sets standards and monitors compliance. Since 2010, it has used a non-complier list to publicly identify countries with deficient anti-money laundering and combating terrorist financing regimes, leading to significant policy change.

[^34]: FATF recommendation 29 requires all countries to establish financial intelligence units to serve as national centers for the receipt and analysis of suspicious transaction reports and other information related to money laundering and terrorist financing.
The next three chapters provide additional information about the FATF and focus in particular on reactions to the non-complier list. Chapter 4 explores market reactions, drawing on interviews with financial industry professionals and leveraging the FATF’s 10-failing-recommendation threshold to identify the causal effect of listing on cross-border bank-to-bank flows. I supplement this analysis with a non-instrumented regression analyzing how listing affects the yield spread on sovereign debt. Chapter 5 discusses different ways that countries react to listing, and analyzes the effect of listing on the probability that a country criminalizes terrorist financing. Chapter 6 hones in on the causal mechanism, demonstrating that listing is most effective for countries that are highly integrated into international markets, and tracing out this process through a case study of Thailand.
<table>
<thead>
<tr>
<th>Country</th>
<th>Listed</th>
<th>Graduated</th>
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<tbody>
<tr>
<td>Afghanistan</td>
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<td>Albania</td>
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<td>Angola</td>
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<td>Antigua and Barbuda</td>
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<td>Bosnia-Herzegovina</td>
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<td>Brunei Darussalam</td>
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<td>Cambodia</td>
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<td>Cuba</td>
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<td>DPRK</td>
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<td>Ecuador</td>
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<td>Ethiopia*</td>
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<td>Sao Tome and Principe</td>
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<td>Uganda</td>
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<td>Ukraine</td>
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<td>Vanuatu</td>
<td>2016</td>
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<td>Vietnam</td>
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<td>Yemen</td>
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<td>Zimbabwe</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>57</strong></td>
<td><strong>47</strong></td>
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Table 3.2: The Non-Complier List (Feb 2010 - Feb 2017) - Table shows the countries included on the non-complier list, the year of listing, and the year of removal (where relevant). Ethiopia was re-listed in 2017. Table does not include countries listed as part of the ICRG process prior to 2010.

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Chapter 4

Blacklists, Bankers, and Bond Yields

Ethiopia has really tried to become a destination for foreign investors. In general, the central bank has been in the process of trying to follow best practices... The central bank didn’t want to be blacklisted at the same time as they were preparing for an external bond issue.

Executive of private bank in Ethiopia

Panama has many reasons to oppose the global expansion of financial integrity regulations. As a top destination for tax evasion and financial secrecy, the government has clear incentives to avoid adopting more stringent policies on financial transparency. Indeed, even when some of the country’s political leaders advocated for new laws to meet Financial Action Task Force (FATF) standards, the domestic financial sector strongly opposed legal and regulatory changes (Author interview with Executive Director, FATF-style regional body, 16 February 2015). Panama’s banking and legal industry benefits significantly from the low-regulation, low-transparency climate, whereby international investors and companies use Panama to evade tax and financial disclosure laws (Lipton and Creswell, 2016).

When the FATF added Panama to its non-complier list in June 2014, however, the politics of this issue shifted rapidly. Panama’s newly-elected President Juan Carlos Varela made passing new anti-money laundering and terrorist financing legislation a top priority for his

1 Author interview, 11 February 2016

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administration. The President had strong financial incentives to act quickly. Panama’s banking community was concerned about the listing, and argued that the FATF list was making it difficult for some Panamanian financial institutions to access the international financial system (Panama Passes Anti-Money Laundering Laws 2015). International credit rating agencies suggested that they expected the government to “take steps to address regulatory shortcomings in the coming year.” The Panamanian government responded to such incentives, acting quickly to pass new legislation less than a year after its initial listing. When the FATF removed Panama from the non-complier list in February 2016, Moody’s described the development as “positive for the sovereign credit of Panama and banks because it confirms that the authorities have the capacity to cope with the risks of money laundering” (Moody’s 2016).

Panama’s story is typical of many countries that end up on the FATF non-complier list. While most listed countries make immediate rhetorical commitments to policy change, market pressures drive the actual improvements in compliance. When the FATF includes countries on its non-complier list, banks and investors view these countries as riskier investment prospects. Listing might lead banks to close or restrict banking transactions through listed countries, or to refuse to do business with individuals from high-risk countries. In the investment sphere, investors might charge a “risk premium” for sovereign debt from listed countries, demanding higher yields to compensate for perceived risk. In both situations, market actors punish listed countries for their non-compliance, creating strong incentives for listed governments to change their policies.

The FATF non-complier list is a useful informational signal because transnational market actors make daily decisions under conditions of high uncertainty. Banks and investors base resource allocation decisions on foreign government reputations. But how do such reputations form? The theory developed in Chapter 2 suggests that information that is credible, precise,
and relevant to actors’ priorities is most likely to affect a target state’s reputation. The FATF is a credible source of information for markets: it is a highly technocratic, apolitical body that has already established expertise and authority in this issue area. For years, the FATF has released detailed monitoring reports on country compliance with relatively few reputational consequences. In 2010, however, reputational effects intensified as the FATF began issuing its non-complier list. The non-complier list is useful for market actors because they have specific, profit-based reasons to care about how a government addresses the problems of money laundering and terrorist financing.

This chapter examines under what conditions market actors will reallocate resources away from countries that pose a high risk of money laundering or terrorist financing. I find that when countries are included on the FATF non-complier list, cross-border bank flows decline and investors demand higher relative yields for sovereign debt. Section 2 draws on qualitative evidence and interviews with close to 15 financial industry professionals to describe under what conditions the FATF list leads to market enforcement. It discusses why market actors like banks and investors need information about country risk to engage in global transactions, and highlights impediments to acquiring such information. It also explains why the FATF non-complier list is useful in addressing such informational gaps, and describes how market actors respond to listing.

Section 3 lays out my empirical strategy. To examine cross-border flows, I exploit a quasi-experiment in FATF procedures to analyze how listing has affected bank-to-bank lending. In 2009, the G-20 called on the FATF to improve its process for dealing with non-compliant countries. The FATF and its affiliates were halfway through the third round of country evaluations (2005 - 2014), and now FATF members had to formulate new procedures for identifying and pressuring non-compliant countries. In line with its technocratic nature, the FATF decided to create a quantitative threshold, whereby all countries that failed on 10 or more of the most important recommendations were automatically eligible for a new
non-complier list. The FATF applied this threshold retroactively to evaluations that had already been completed. As a result, close to 80 non-FATF member countries suddenly found themselves under consideration for the FATF non-complier list on the basis of previous monitoring reports. I exploit this unexpected cut-point using a fuzzy regression discontinuity design to examine how listing affected financial flows between 2010 and 2015. I supplement this approach with a non-instrumented analysis of how listing has affected sovereign spreads within countries across time. By analyzing both cross-border flows and sovereign spreads, I am able to show that the FATF non-complier list has a broad economic impact.

Section 4 discusses the data and how I measure my key variables. My analysis draws data from the Bank of International Settlements, the International Monetary Fund, and the Economist Intelligence Unit. I also rely on data that I coded from FATF monitoring reports and listing announcements. Section 5 presents my results, which show that cross-border bank flows have declined to listed countries and that investors view listed countries as significantly more risky. Section 6 concludes.

4.1 Reputation in the Global Economy

In today’s globalized economy, market actors often require information about foreign governments. Banks build transnational networks so that individuals and companies can send money overseas, import or export goods, and buy foreign stocks and bonds. Investors purchase debt from emerging economies and high-income countries, while companies build transnational supply chains and acquire properties overseas. In all of these cases, market actors base resource allocation decisions in part on foreign government reputations. Because market decision-making is interdependent, market actors must consider not only their own beliefs about a foreign government’s policies and practices, but also how other market actors are likely to assess the same country. Reputation is thus doubly important for decision making.
Market actors will construct beliefs about foreign countries based on their own specific profit-maximization functions. For banks, this profit function reflects domestic regulatory priorities, the shadow of government enforcement, and concern about reputational damage among shareholders and customers. Investors, on the other hand, are interested in any information that pertains to a country’s willingness or ability to repay its debt obligations. The FATF non-complier list is likely to be a useful informational input for both types of actors, leading them to reallocate resources away from non-compliant states.

4.1.1 Bank Demand for Country Risk Information

A bank’s profit function is tied directly into the global effort to protect the integrity of the financial system. FATF recommendations require countries to regulate their banking sectors to address the risk of money laundering and terrorist financing. One of the FATF’s most important recommendations, for example, requires banks, corporate service providers, remittance services, and lawyers to maintain “customer due diligence procedures,” taking measures to verify customer identities using a risk-based approach. In effect, this recommendation requires market actors to assess the risk of money laundering and terrorist financing emanating from different jurisdictions, creating a perfect audience for the non-complier list. Because of the influence of the FATF global network, most countries in the world have laws on this issue. Banks and other financial service providers are required to create standardized procedures for determining whether customers are low, medium, or high risk for money laundering and terrorist financing. A key input into this risk process is the customer’s country of origin. Banks typically subject customers from high-risk jurisdictions to longer screening and administrative procedures. In some cases, financial institutions might even opt to forgo all business with certain high-risk countries (Collin, Cook and Soramaki [2016]).

In addition to regulatory incentives, many banks face the possibility of government enforcement action if they fail to implement regulations on customer due diligence. The United
States government in particular has levied significant financial penalties against banks that fail to comply with the laws. 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]. Other jurisdictions like the United Kingdom and Hong Kong have also penalized large international banks by levying large fines for compliance failures.⁵ Even banks with no money laundering or terrorist financing exposure often establish customer due diligence systems because they fear government enforcement action (Author interview with MSCI Executive, 25 September 2015).⁴

Banks also need information on money laundering and terrorist financing risk because they are likely to suffer significant reputational damage if they are involved in a financial integrity scandal. Reputational damage can lead to financial costs, or at the most extreme, complete collapse. The US government’s discovery that Riggs Banks was helping several dictators launder money resulted in relatively small financial penalties (fines totaling 59 million US dollars), but led to the bank’s demise. In a period of eight months, share prices dropped 20 percent, equivalent to approximately 130 million US dollars [Jamieson 2006]. Given this stark example, it is perhaps unsurprising that bank officials are concerned about reputational effects. As one Citibank official described it, “no firm wants the reputational damage of having been used as a vehicle for criminal activity, or worse, as a channel for financing terrorism” (Author interview with Citibank official, 28 August 2015). Indeed, damage to reputation is often used as a way to sell risk management systems to financial actors (Author interview with Thomson Reuters’ World-Check official, 28 September 2015).

³Unilateral enforcement action occurs against both domestic and foreign-owned banks operating within a jurisdiction. In January 2017, for example, the United Kingdom’s Financial Conduct Authority and the New York State Department of Financial Services coordinated to fine German-owned Deutsche Bank a combined total of 500 million pounds [Martin 2017].

⁴MSCI provides research-driven insights and tools for institutional investors. Its clientel include 99 of the top 100 global investment managers. For more information, please see: https://www.msci.com/our-story
Due to regulatory, enforcement, and reputational incentives, banks devote significant resources to assessing a country’s risk of money laundering and terrorist financing. In 2017, banks and other financial actors are expected to spend more than 8 billion US dollars on anti-money laundering and combating terrorist financing compliance software and programs (Pelaez 2016). Large banks have sizable compliance departments and complex risk algorithms to assess the risk of doing business with banks and customers in other countries. Banks compile their own information, purchase software systems from companies like Thomson Reuters and Accuity, and hire employees to oversee the compliance process. But managing these risk models is an incredibly complex and cumbersome task, particularly because regulators expect banks to have very defined methodologies. National regulation requires banks not only maintain but also validate their risk models, creating an additional compliance burden.

The FATF non-complier list is an ideal input into this process. The FATF is a well-known and credible institution; it issued the standards that most governments use to regulate their financial sectors. The FATF also meets with banks and other financial actors on an annual basis through its “Private Sector Consultative Forum.” Because the FATF is known as a credible, technocratic institution, banks view its informational signals – and in particular, the non-complier list – as important sources of information. One financial industry professional posited that the FATF’s value to banks is linked to how the organization is perceived by the United States and its regulators (Author interview with MSCI official, 25 September 2015). Because of the FATF’s authority and credibility in this issue area, US regulators expect that banks will adjust their risk models to account for the FATF non-complier list.

The FATF has produced reliable monitoring reports on non-compliance for nearly three decades, however, its monitoring has had the greatest impact when released through “black-

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5The Forum provides an opportunity for the FATF to learn more about the private sector’s views and concerns related to financial integrity.

6These reports have been publicly available since the start of the third round of mutual evaluations in 2006.
lists\footnote{Here, I rely on the conventional use of the word “blacklist” to indicate a list of unsavory, underperforming, or somehow deficient states.} like the non-complier list. Interviews with financial industry professionals suggest that the precision of the monitoring clearly matters. The FATF’s lengthy country-specific “mutual evaluation reports” provide much more detailed insights into non-compliance in each state, but they are difficult to integrate into risk models.\footnote{One of financial industry professional reported that although his bank ranks countries by anti-money laundering risk and weighs heavily the FATF non-complier list, the FATF mutual evaluation reports never come into consideration (Author interview, 25 September 2015).} In contrast, the non-complier list is useful “purely because it’s a quantitative measure that you can put in a risk model” (Author interview with Citibank Compliance Executive, 28 August 2015). For smaller banks, the FATF non-complier list is even more essential, since these entities often do not have the resources to build compliance departments or purchase comprehensive software systems. Small banks instead rely on the FATF non-complier list as a defensible way of grouping countries into risk categories.

4.1.2 Investor Demand for Country Risk Information

Unlike banks, investors have no specific regulatory or reputational reasons to care about a country’s money laundering or terrorist financing risk. Investors are interested, however, in any information that might indicate that a government is less likely to repay its debt. Investors face significant uncertainty over sovereign debt because contracts are unenforceable and governments can, in theory, always print more money if they need to repay borrowers (Abdelal and Blyth, 2015). They need information about a borrowing government’s ability and willingness to repay its debt. While a government’s ability to repay its debt is typically tied to factors like the current level of debt, exports, economic growth, and exchange rate stability, a government’s willingness to repay is much harder to assess. Since a government will choose its strategy by weighing the benefits of compliance against the cost of reneging, investors need information about a government’s political preferences and priorities.
Investors consider many tangible and intangible factors when they form beliefs about a foreign government’s willingness to repay its debt. Ratings companies like Moody’s and S&P rely on quantitative and qualitative data, as well as harder-to-measure metrics like a government’s “propensity for ‘orthodox’ vs. ‘heterodox’ policy responses when under acute debt-service pressure” (Bhatia 2002 27). Investors may form beliefs about a government’s type based on past behavior, such that when a government acts counter to its type, this action improves or damages its reputation (Tomz 2007b). Investors may also evaluate a government based on how they view similar, “peer” countries (Brooks, Cunha and Mosley 2014) or based on membership in international organizations (Gray, 2013). Overall, investors are looking for any type of information that signals how a government will manage competing priorities.

The FATF non-complier list signals information about both a country’s ability and willingness to repay its debt obligations. From an economic standpoint, listed countries are likely to suffer clear financial penalties due to market enforcement from banks. As discussed above, banks have reputational and regulatory incentives to restrict business with individuals and banks in listed countries; in some cases, banks may choose to avoid doing business altogether with risky countries. When banks restrict foreign transactions, key economic inputs such as trade become significantly more costly. The majority of cross-border flows are conducted in US dollars or Euros; when financial institutions close business relationships with domestic banks in a listed country, they cut off access to these key currencies (Durner and Shetret 2015 19). In trade-dependent regions like the Caribbean, this “de-risking” process has had a major impact on the macroeconomic health of countries (Williams 2016).

The FATF non-complier list also signals information about a country’s willingness to repay its debt obligations. When the FATF includes a country on the non-complier list, Tomz (2007b) illustrates this point, writing “When a government pleads poverty in negotiations with international creditors, this almost never implies that the government is penniless. Rather, it signals a lack of political will to elevate the foreign debt over other concerns.”
this action signals that a government is lagging behind in financial regulation and failing to implement best practices. More importantly, however, it also provides information about a government’s preferences and political priorities. Most listed countries have had ample opportunities to avoid being listed. Once the FATF determines that a country is eligible for the non-complier list, it has a year to change its policies to prevent being listed. Given the possibility of significant economic consequences from listing, if a government fails to avoid the non-complier list, this lack of action is a strong signal that the government prioritizes other considerations over its reputation in financial markets. Listing also reduces uncertainty about how other investors are likely to evaluate a particular government, thus coordinating expectations across actors.

4.1.3 Market Responses to the FATF List

Market enforcement by banks is likely to lead to significant financial consequences for listed countries. Banks integrate the FATF non-complier list directly into their risk models; these models, in turn, drive bank procedures for verifying customer identities and monitoring potential anti-money laundering transactions. Individuals and companies in listed countries may experience delays in transferring money or conducting business abroad. When the FATF moves countries up to higher levels of listing, governments may actually advise financial institutions not just to modify risk procedures but to conduct enhanced due diligence on customers from the listed jurisdiction. For example, when the FATF moved Turkey up to a higher listing level in June 2011, the FATF called on its members and associates to consider enhanced due diligence procedures when conducting transactions with Turkey. The Association of Certified Anti-Money Laundering Specialists, a transnational network of financial integrity specialists, advised its members that “undertaking enhanced due diligence is the

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10The FATF non-complier list is actually composed of four levels of lists targeted toward non-compliant states. Chapter 3 provides more details on this multi-level process.
only way to mitigate the risk of being used as a conduit for criminal or terrorist activities” when doing business with Turkey (Hanley-Giersch 2012).

In practice, the repercussions of bank enforcement can take many forms. In some cases, existing customers may not feel much of an effect but banks will be reluctant to establish business relationships with new clients or jurisdictions (Author interview with Citibank Compliance Executive, 28 August 2015). During Thailand’s time on the non-complier list, Thai financial institutions encountered unexpected difficulties obtaining permits to open branches in EU countries, and an EU bank even contemplated scraping a deal to lend money to Thai banks (Author interview with Thai government official, 14 February 2016). Over the last five years, international banks have increasingly opted to pull out of high-risk financial jurisdictions, sometimes leaving individuals and companies in such countries without access to major currencies. In some cases, this process occurs in a domino pattern, as actions in one country lead to ripple effects across the globe. For example, US banks have increased due diligence against Australian banks, which are viewed as higher risk due to their remittance-heavy relationships with many small island states in the Pacific. In response to increased US due diligence, Australian banks have had to change their business relationships with other banks in the region. In one case, an Australian bank cut relationships with remittance services across the board (Alwazir et al., 2017).

Although bank enforcement against listed countries could take a variety of forms, the consequences of such action are straightforward – banks and customers in listed countries should find it harder to access international capital. Both risk profiling and enhanced due diligence are likely to lead to a decline in international banks lending to banks in listed countries.

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11 Anti-money laundering professionals generally view the remittance sector as posing a high risk of money laundering or terrorist financing (Alwazir et al., 2017).
• **Cross-Border Lending Hypothesis:** International bank loans to banks in listed countries should decline when countries are on the non-complier list, compared to non-listed countries.

## 4.2 Identifying the Causal Effect of Listing

FATF listing decisions are the outcome of a bargaining process between FATF members. As a result, listing may reflect unobserved country-specific factors that could also influence cross-border flows. FATF member states, for example, may have more diplomatic power and technical capacity than non-member states to advocate against the possibility of listing. As a result, the FATF may be less likely to list FATF member countries, even if they have the same level of non-compliance as non-member states. If the FATF is more likely to list countries with robust financial sectors that receive significant lending, coefficient estimates in a standard regression are likely to be downward biased. Alternatively, if the FATF is more likely to list countries with weak financial sectors and low bank-to-bank lending, coefficient estimates would be biased toward finding an effect.

I overcome the endogenous assignment of listing by leveraging a quasi-experiment that occurred as a result of a change in FATF bureaucratic procedures. In 2009, halfway through its third round of mutual evaluations, the FATF established a listing eligibility threshold that was based on the results of mutual evaluation reports. Only FATF members were involved in creating the threshold, but the threshold applied to both FATF and non-FATF member countries. As a result, many non-FATF countries suddenly found themselves unexpectedly eligible for listing. I use a fuzzy regression discontinuity design that exploits this listing eligibility threshold as an instrument to identify the causal effect of listing for countries right around the threshold (8-to-11 failing recommendations).

12 Indeed, since February 2010, the FATF has listed 57 countries, only two of which were FATF member states.
4.2.1 The FATF Non-Complier List: Eligibility Criteria

Exogenous shocks to the global system have twice generated significant changes in the FATF. In 2001, the 9/11 terrorist attacks led the FATF to expand its anti-money laundering mandate to include combating terrorist financing. The FATF adopted eight new recommendations on combating terrorist financing and began to evaluate compliance with these recommendations when its third round of mutual evaluations began in 2004. Over the last few years, terrorist financing has come to dominate the agenda, with the FATF conducting a global survey of counterterrorism policies\(^\text{13}\) and adopting a new consolidated strategy on combating terrorist financing\(^\text{14}\).

The second shock that significantly changed FATF procedures was the global financial crisis. When G-20 leaders met in Washington, DC in November 2008, they agreed on an action plan to implement five principles for reform to prevent a worsening of the crisis. One of the five principles was “Promoting Integrity in Financial Markets.” G-20 leaders called for measures to strengthen “cross-border cooperation to protect the international financial system from illicit actors. In cases of misconduct, there should be an appropriate sanctions regime” (G-20 2008). The FATF, as the lone regulatory body dealing with illicit finance, interpreted the G-20 statement as a call to revitalize their non-compliance efforts. Within months, FATF members had circulated new procedures for identifying countries that were failing to implement FATF recommendations on terrorist financing or money laundering, and by February 2010, the FATF published its new non-complier list.

How did the FATF decide which countries were eligible for listing? Member states began by trying to identify the most important FATF recommendations. At the time of the financial crisis, the FATF was halfway through its third round of evaluations (2005 - 2014) to assess country compliance with all 49 of the FATF’s recommendations. To assist eval-

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\(^{13}\)The Terrorist Financing Fact-Finding Initiative

Table 4.1: FATF Rating Definitions - 2004 Methodology

<table>
<thead>
<tr>
<th>Rating</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compliant</td>
<td>Meets all essential criteria of the recommendation</td>
</tr>
<tr>
<td>Largely Compliant</td>
<td>Minor shortcomings, with a large majority of essential criteria met</td>
</tr>
<tr>
<td>Partially Compliant</td>
<td>Some substantive action and complies with some of the essential criteria</td>
</tr>
<tr>
<td>Non-Compliant</td>
<td>Major shortcomings, with a large majority of essential criteria not met</td>
</tr>
</tbody>
</table>

Table 4.1: FATF Rating Definitions - 2004 Methodology

But while evaluators assessed compliance with all 49 recommendations, FATF members generally agreed that some recommendations were more important than others.

Following extended discussions, FATF members decided in late 2008 to identify 16 of the 49 recommendations as “core and key” – i.e. most important or most essential. The FATF’s 16 most important recommendations include the criminalization of money laundering and terrorist financing, customer identification and record keeping requirements, international cooperation and legal assistance, and freezing and confiscating illicit assets. According to former FATF President Antonio Gustavo Rodrigues, the FATF decided on these specific 16 recommendations as part of a “pragmatic approach,” given the FATF’s capacity limitations. In his view, “a country can have a reliable anti-money laundering system even without some of the details in the evaluation but it cannot be a workable system if major aspects are missing” (Author interview, 29 March 2017).

Once FATF members identified the 16 most important recommendations, they had to agree on a threshold for listing eligibility. The FATF determined that ratings of non-

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15In rare cases, countries may also receive rating of “not applicable,” indicating that 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” (FATF-GAFI, 2009d).

16In an interview with the author, a MONEYVAL official described the core recommendations as “the building blocks of an anti-money laundering/combating terrorist financing regime, without which anything would be pointless,” while key recommendations were described as “extremely important, but to a lesser extent” (Author interview, 27 January 2015).

17A full list of the 16 key and core recommendations is available in the Appendix.
compliant or partially compliant were indicative of significant problems, and therefore represented a workable standard of “failure.” FATF members then began discussing the substance of the recommendations, trying to identify how many “failing” ratings should bump a country into listing eligibility. According to an FATF-style regional body Executive Secretary, who was directly involved in the creation process, FATF member states and secretariat officials focused on the substance of the recommendations, arriving at 10 failing recommendations as the threshold for listing eligibility because it represented a “preponderance of recommendations” (Author interview, 30 June 2016). Former FATF President Rodrigues, who presided over the creation of the new listing process, echoed this sentiment, suggesting that FATF members “started discussing the substance and ended with ten” (Author interview, 29 March 2017).

The FATF adopted new procedures for its International Cooperation Review Group (ICRG), which produces the non-complier list, in June 2009. Per the procedures, countries that received non-compliant or partially compliant ratings on 10 or more of the 16 core and key recommendations were automatically referred to the ICRG review process. The procedures also stipulated automatic referral for countries that failed to participate in FATF-style regional bodies and the mutual evaluation process, and for countries nominated for consideration by FATF members or members of regional bodies. According to the FATF, the procedures were intended to create “an evergreen pool of jurisdictions that warrant...review” \(\text{[FATF-GAFI, 2009b, 5]}\). The ICRG would then review all eligible jurisdictions to determine which ones warranted closer consideration and possible inclusion on the non-complier list.

The FATF’s 10-failing-recommendation threshold introduced randomness into the listing process. Although the FATF compliance scale is based on a strong methodology document, compliance ratings of “largely compliant,” “partially compliant,” and “non-compliant” depend significantly on how a particular evaluation team interprets and assesses a recommendation. Despite FATF efforts to ensure comparability, considerable discrepancies exist across
reports. For example, FATF Special Recommendation V focuses on international cooperation on terrorist financing, and is one of the 16 “core and key” recommendations. A close examination of country ratings on this recommendation reveals that the same compliance problem often generates different ratings. Andorra, Bahrain, and China, for example, all had gaps in their terrorist financing laws, but nonetheless, they received ratings of “largely compliant.” In contrast, the Kyrgyz Republic, Mexico, and Turkey, had similar gaps in their terrorist financing laws but received ratings of “partially compliant” on the same recommendation. Table B.1 in the appendix illustrates this discrepancy more clearly, comparing the Special Recommendation V rating for all countries that were evaluated prior to 2009 and received failing scores on 9 or 10 of the 16 most important recommendations.

The introduction of a 10-failing-recommendation threshold made such discrepancies substantively meaningful. Prior to June 2009, if a team of evaluators rated a country as “partially compliant” with a key or core recommendation when the country should have been rated “largely compliant,” there were few consequences. But once the FATF created the 10-failing-recommendation threshold, this small difference in rating could make a country suddenly eligible for listing. Conversely, a country that should, on the basis of its deficiencies, be eligible for listing, could end up below the threshold. The end result of such shifts is that countries just above the threshold were quite similar in terms of compliance as countries that fell just below the threshold.

4.2.2 Identification Assumptions

I employ a fuzzy regression discontinuity design (RDD), which uses falling above the 10-failing-recommendation threshold as an instrument that increases the probability of listing. I focus my analysis on those non-FATF member countries that had already been evaluated

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18SR.V. requires that each country provide other countries mutual legal assistance or information exchange, as well as assistance with criminal, civil, and administrative investigations relating to the financing of terrorism, terrorist acts, and terrorist organizations.
as of June 2009.\textsuperscript{19} Within this group, I compare cross-border bank-to-bank lending for countries right above and right below the 10-failing-recommendation threshold. This approach requires making several assumptions about the effect of the instrument – the 10+-failing-recommendation threshold – on the outcome. These assumptions are local randomization, monotonicity, and the exclusion restriction.

Local Randomization

The first assumption is local randomization, meaning that it is somewhat random whether a country ends up above or below the threshold within the window of analysis (8-to-11 failing recommendations). In other words, there should be no significant differences between countries with 8 or 9 failing recommendations and countries with 10 or 11 failing recommendations. This assumption is plausible for several reasons. First, as previously discussed, a unique team of assessors evaluates each country’s compliance and interprets the FATF methodology document in its own way. For many of the recommendations, there is considerable ambiguity as to what constitutes largely compliant (a “passing” score) vs. partially compliant (a “failing” score). Each evaluation team interprets and assesses the standards slightly differently, depending on their training, experience, and the context of the country. As a result, there is a limited amount of random noise introduced into the evaluation process.\textsuperscript{20} Second, the FATF evaluation process takes about 10 years per round, which means that countries are evaluated at different points in time. Countries have limited control over when they are evaluated\textsuperscript{21} and as a result, some countries have much longer than others to improve compliance.\textsuperscript{22}

\textsuperscript{19}This is when the FATF established its new listing eligibility criteria.
\textsuperscript{20}Note that this as-if random assumption does not imply that the evaluation process is politically biased or that the FATF is not a technocratic organization. Rather, it is a natural outgrowth of having many different evaluators, each of whom interprets the standards in a slightly different manner.
\textsuperscript{21}In general, the timing of the latest evaluation is based on when the country has its last evaluation.
\textsuperscript{22}In year one of the evaluation cycle, for example, a country may have 11 failing recommendations, but by year four, it may only have 8. The country’s score will then depend in part on when it happens to be evaluated, rather than underlying country characteristics.
The primary way that this assumption could be violated is by sorting. Interviews suggest that after the FATF created the 10-failing-recommendation threshold, countries fought “tooth and nail to avoid the ICRG process” (Author interview with MONEYVAL official, 27 January 2015). Because of the FATF’s monitoring and plenary procedures, it is difficult for countries to improve more than one or two ratings, but for countries close to threshold, changing a few ratings could be enough to remove ICRG eligibility. While this sorting process almost certainly occurred after the FATF created the threshold, it seems highly unlikely to have taken place prior to 2009, when the FATF had yet to identify the 16 most important recommendations or to establish the 10-failing-recommendation threshold. For this reason, I limit my analysis to countries that had mutual evaluation reports adopted before June 2009.

Sorting could still be a problem if the FATF created its 10-failing-recommendation threshold with certain countries in mind. Officials involved in the creation of the listing eligibility procedures deny that this was the case, suggesting instead that FATF members created the threshold based on discussions of what constituted the most problematic level of non-compliance (Author interview with Executive Secretary of FATF-style regional body, 30 June 2016; Author interview with former FATF President, 29 March 2017). Because FATF members set the 10-failing-recommendation threshold, however, it is possible that they may have taken into account the results of their own mutual evaluation reports. China and Mexico, for example, received failing ratings on 9 of the 16 “core and key” recommendations, but they were relatively new FATF members, joining in 2007 and 2000 respectively. It seems quite possible that the FATF would have taken steps to avoid listing some of its newest members. In contrast, the FATF may have intentionally targeted fellow member Turkey, which received failing ratings on 10 of the 16 recommendations, and was listed in February 2010. When the FATF adopted Turkey’s mutual evaluation report in 2007, the report revealed significant de-

\[23\] Indeed, during the 2000s, the FATF intentionally sought to enhance institutional legitimacy by inviting rising powers to join, expanding to include Argentina, Brazil, China, India, Korea, Mexico, Russia, South Africa, and most recently, Malaysia.
iciencies, including problems with its criminalization of terrorist financing. Given Turkey’s strategic importance to international counter-terrorism efforts, and also the FATF’s then-unsuccessful efforts to pressure the Turkish government to adopt new laws, it is possible the FATF may have chosen 10 as the threshold so that Turkey would be eligible for the listing process.\(^{24}\)

The FATF may have taken into account the results of its members’ mutual evaluation reports; it seems unlikely, however, that the FATF considered whether non-FATF members would end up eligible for listing. Because of the FATF’s unusual institutional design, where the FATF’s 35 member states set standards and rules for all countries, non-FATF member countries were relatively uninvolved in the creation of the new listing procedures. The FATF membership alone was responsible for designing the threshold and agreeing on the new procedures, and there is no qualitative evidence that non-FATF members influenced the final eligibility threshold.

Empirical evidence supports this view. Figure \([4.1]\) shows the distribution of mutual evaluation reports for non-FATF member countries evaluated prior to 2009. Specifically, each bar represents the number of countries that received a given number of failing (non-compliant or partially compliant) ratings on the 16 most important recommendations. While the figure suggests a slight bump in countries below the threshold compared to right above (7 countries vs. 5 countries), this bump is consistent with the general lack of a clear pattern for countries that received between 8 and 12 failing recommendations.\(^{25}\) Balance tests also support this view, revealing no significant statistical differences on key covariates likely to affect cross-border flows. Table \([4.2]\) shows these results.

\(^{24}\)Indeed, even after the FATF included Turkey on the non-complier list, it was one of the most intransigent states; the FATF actually threatened to suspend Turkey’s membership if it did not change its laws (Dombey 2012).

\(^{25}\)Due to the small number of possible values that the running variable (number of failing recommendations) can take, I am not able to perform a McCrary sorting test (McCrary 2008) to detect the possibility of sorting around the threshold.
Figure 4.1: Distribution of Failing Recommendations - The figure shows the distribution of third-round mutual evaluation reports adopted prior to 2009 for non-FATF members. The height of each bar represents the number of countries that received a given number of failing (non-compliant or partially compliant) ratings on the 16 “core and key” recommendations. The FATF considers countries that receive 10 or more failing recommendations to be eligible for possible listing.

An additional way to probe the local randomization assumption is by examining how the possibility of listing may correlate with cross-border liabilities for countries around the threshold. Figure 4.2 shows this “intention-to-treat” effect for countries with between 8 and 11 failing recommendations. The majority of cross-border liabilities for countries with 10 failing recommendations fall below 5 billion US dollars, and listed countries are at the very bottom of the distribution.\textsuperscript{26} Cross-border liabilities for countries with 11 failing recommendations are more widely dispersed.

\textbf{Monotonicity}

\textsuperscript{26}The plot omits a small number of observations where cross-border flows are above 50 billion US dollars. None of these observations are for listed countries.
### Table 4.2: Balance Tests: 8-to-11 Failing Recommendations Window

<table>
<thead>
<tr>
<th>Variable</th>
<th>Below the Threshold (8 - 9 Failing Recs)</th>
<th>Above the Threshold (10 - 11 Failing Recs)</th>
<th>P-Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cross-Border Liabilities (log)</td>
<td>8.39</td>
<td>7.88</td>
<td>0.26</td>
</tr>
<tr>
<td>GDP (log)</td>
<td>23.96</td>
<td>23.87</td>
<td>0.80</td>
</tr>
<tr>
<td>Exports (log)</td>
<td>23.14</td>
<td>23.10</td>
<td>0.93</td>
</tr>
<tr>
<td>Inflation</td>
<td>4.20</td>
<td>3.81</td>
<td>0.58</td>
</tr>
<tr>
<td>Financial Account (log)</td>
<td>21.39</td>
<td>21.30</td>
<td>0.82</td>
</tr>
<tr>
<td>Democracy (Polity)</td>
<td>3.44</td>
<td>4.56</td>
<td>0.49</td>
</tr>
<tr>
<td>US Ally</td>
<td>0.25</td>
<td>0.30</td>
<td>0.61</td>
</tr>
</tbody>
</table>

The second assumption is monotonicity, meaning that the instrument affects all actors in the same way. Monotonicity requires us to assume that falling above the 10-failing-recommendation threshold will always either increase a country’s probability of being listed or have no effect. In other words, it should never be the case that because a country fails on 10 or more recommendations, it is less likely to be listed than it would be with a smaller number of failing recommendations. This assumption seems plausible for several reasons. The FATF developed the 10-failing-recommendation threshold in order to (1) systematize the process of listing, and (2) limit the number of countries that the ICRG would have to evaluate. The FATF’s rationale for making listing more technocratic was based in part on lessons learned from the FATF’s previous “blacklist” effort (2000 - 2006), which many observers criticized as politicized and illegitimate because it was based on non-transparent procedures that deviated from FATF standards. If the FATF had violated its procedures, it would have opened the new listing process to old critiques. Targeting countries with fewer than 10 failing recommendations would also have expanded the pool of eligible jurisdictions, which FATF members wanted to avoid due to capacity limitations. The monotonicity

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27 See, for example, accounts by Tsingou (2010) and Gordon (2010).
28 Many officials from the FATF and from FATF-style regional bodies expressed this sentiment during conversations with the author.
Figure 4.2: Cross-Border Liabilities by Number of Failing Recs - The scatterplot shows cross-border liabilities (2010 to 2015, in billions US dollars) by number of failing recommendations. Grey dotted line represents the FATF listing eligibility threshold of 10 or more failing recommendations. Data includes only non-FATF countries that had been evaluated as of June 2009.

assumption is also supported empirically – during the third round of mutual evaluations, the FATF never listed an evaluated country with less than 10 failing recommendations.\footnote{The FATF has listed several countries that refused to participate in the mutual evaluation process, but these countries are, by necessity, excluded from the instrumental variable analysis.}

**Exclusion Restriction**

The final IV assumption is the exclusion restriction, which requires that the instrument only affect the outcome through the treatment. In the FATF case, the exclusion restriction requires that falling above the threshold (having 10+ failing recommendations) only affects cross-border flows by increasing the probability of FATF listing. Put another way, having 10 or more failing ratings should have no direct effect on bank-to-bank lending. At the extremes, the exclusion restriction is likely to break down – countries that failed on 15 or 16 recommendations most likely have systematic and widespread problems with financial
integrity. Even without the FATF non-complier list, banks may be aware of such difficulties and may evaluate risk accordingly. Within the 8-to-11 window, however, banks are less likely to be aware of differences between countries since reports provide no aggregate rating. Even if banks were aware of the ICRG procedures post-June 2009, it seems unlikely that they would immediately restrict lending given the uncertainty of eventual listing and the fact that more than 80 countries were eligible.

Interviews with financial professionals support the notion that banks do not reallocate resources on the basis of mutual evaluation reports. Smaller banks do not have the capacity or manpower to integrate mutual evaluation reports into their risk management systems. Even in larger banks, the mutual evaluation reports are less important than the non-complier list. A Citibank Compliance Executive indicated that mutual evaluation reports matter much less than the non-complier list because they are difficult to quantify (Author interview, 28 August 2015). A compliance official from Credit Agricole, one of the largest French banks, reported that mutual evaluation reports “never came into the equation” while evaluating country risk (Author interview, 25 September 2015).

4.3 Measuring Market Enforcement

To test my hypothesis, I examine the effect of the FATF non-complier list on cross-border bank liabilities over the period of 2010 to 2015. My primary analysis is structured around an instrumental variable approach, which uses whether countries fail on ten or more recommendations as an instrument for listing. I limit my analysis to non-FATF member countries with comparable levels of compliance, which I define as failing on at least 8 and not more than 11 of the FATF’s “core and key” recommendations in a mutual evaluation report adopted pre-2009. Within this window, I use the 10+-failing-recommendation threshold

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30 An Imbens-Kalyanaraman optimal bandwidth test suggests 3.4 is the optimal bandwidth; however, because my running variable (number of failing recommendations) is discrete, I round up to a bandwidth of 4.
The instrumental variable analysis of cross-border flows includes 22 countries, 2 of which were listed by the FATF (Bolivia and the Kyrgyz Republic). Compared to the full sample of listed countries, the two listed countries included in my analysis are poorer and more democratic than the average listed country in the full sample.\footnote{The average GDP per capita for the full listed sample is 3571, compared to an average of 1608 for Bolivia and Kyrgyz Republic. The average polity score for the listed sample is 2.9, while the average for Bolivia and Kyrgyz is 7.} Cross-border liabilities for the two samples also somewhat diverge, with the broader listed sample having a mean of 6.83 billion and a median of 1.99 billion, while the smaller IV sample has a mean of 2.01 billion and a median of 1.83 billion.

The FATF updates its non-complier list three times a year, but data on cross-border bank flows is only available on a quarterly basis. As a result, I examine how an FATF listing announcement affects cross-border flows in the following quarter. For example, if the FATF updates its non-complier list in quarter 1 (January - March), I examine cross-border flows for quarter 2 (April - June). The FATF does not update its list in quarter 3, so I exclude quarter 4 from the analysis. Table 4.3 provides more details on this approach.

### Table 4.3: Unit of Observation - Cross-Border Flows

<table>
<thead>
<tr>
<th>IV: FATF Listing Announcement</th>
<th>DV: Cross-Border Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quarter 1, Year T Jan - March</td>
<td>Quarter 2, Year T April - June</td>
</tr>
<tr>
<td>Quarter 2, Year T April - June</td>
<td>Quarter 3, Year T July - Sept</td>
</tr>
<tr>
<td>Quarter 4, Year T Oct - Dec</td>
<td>Quarter 1, Year T+1 Jan - March</td>
</tr>
</tbody>
</table>

The table shows the correlation between the number of failing recommendations and key economic and political variables for all non-FATF member countries evaluated as of June 2009. Data for variables is from the year 2010.
4.3.1 Dependent Variable: Cross-Border Liabilities

If my theory is correct, then listing should lead to market enforcement, i.e. a redistribution of resources away from non-compliant states. While a number of market actors could behave in this manner, qualitative research suggests banks are the most likely actor to redistribute resources based on listing. To examine changes in bank behavior, I analyze how listing affects cross-border lending patterns.

My data on cross-border liabilities is drawn from the Bank for International Settlements (BIS) locational banking statistics.\textsuperscript{32} This data set provides information about outstanding claims and liabilities as reported by internationally active banks located in the 44 reporting countries. Because these banks report international cross-border flows, the data covers banks in more than 200 countries. BIS estimates the statistics capture about 95 percent of all cross-border interbank business. I focus specifically on bank-to-bank liabilities, that is, the money that banks in a given country owe to international banks. For the 22 countries in the data set, this variable ranges from 7.1 million (Gambia) to 31 billion (Bahamas). Because the data is highly skewed, I transform the dependent variable by logging it.\textsuperscript{33}

4.3.2 Explanatory Variables

The primary independent variable of interest is whether, at a given point in time, a country is on the non-complier list. I collect data at the unit of observation level on FATF listing announcements. Since February 2010, the FATF has issued updates to its non-complier list three times a year (February, June, and October), under the auspices of its ICRG process. ICRG regional bodies, which are co-chaired by an FATF member state and a non-FATF

\textsuperscript{32}BIS is an international financial organization owned by 60 member state central banks. Together, these countries represent about 95 percent of world GDP.

\textsuperscript{33}Multiple regression assumes that the distribution of the data approximates a normal distribution but this assumption is clearly violated when the dependent variable is highly skewed. By transforming the variable through logging, the relationship between the independent and dependent variable comes more linear, producing a regression equation that more closely meets the requisite conditions for accurate statistical inference.
member, review states that are eligible for inclusion on the list and after a year-long process, determine which states will be publicly identified. Once countries are included on the non-complier list, they must address all identified deficiencies in order to be removed from the list. Based on FATF listing announcements, I create a dichotomous indicator $Listing$, which indicates whether a country is on the non-complier list at any time. In the cross-border bank analysis, about 5 percent of observations are coded as 1’s.

To provide additional support for my theory, I also analyze the effect of listing on cross-border liabilities while controlling for several possible confounders. [Bruno and Shin (2015)] offer a simple model of cross-border bank flows, where global banks raise US dollar funding and then lend to banks in other countries. Local banks then draw on cross-border funding to lend to local borrowers. Based on this model, I include controls for $GDP$ and $Inflation$ to account for the fact that larger economies might have a greater demand for credit, while high inflation might limit the credit supply.\(^3\) I also include a control for the country’s $Real\text{ }Exchange\text{ }Rate$, which shows the ratio of the price level abroad and the domestic price level.\(^4\) Exchange rate is a proxy for how markets view the strength of a country’s economy; as exchange rates increase, cross-border liabilities are likely to decline.\(^5\)

### 4.3.3 Instrument: 10-Failing-Recommendation Threshold

To overcome endogeneity, I rely on whether a country falls above the 10-failing-recommendation threshold as an instrument that increases the probability of listing (within the window). I code this variable based on the results of each country’s third round mutual evaluation report. Between 2005 and 2014, every FATF member and affiliate country was evaluated once.\(^6\) I add up the number of non-compliant or partially compliant

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\(^3\)I transform GDP by logging it to address the high skew of the distribution.
\(^4\)Foreign price level is converted into domestic currency units using the nominal exchange rate
\(^5\)Bruno and Shin (2015) include additional variables in their analysis; however, due to data availability limitations and the small size of my sample, I include only these three controls.
\(^6\)Countries that are members of MONEYVAL, the Council of Europe’s FATF affiliate organization, are the exception to this statement. During this period, MONEYVAL actually evaluated each country twice.
ratings that each country received on the FATF’s 16 key and core recommendations. The data only includes non-FATF member countries that were evaluated prior to the FATF’s creation of the 10-failing-recommendation threshold. A first-stage test examining the effect of falling above the threshold on listing confirms that the instrument is strong (F-statistic: 24.029).

4.4 Results: Listing Drives Market Enforcement

The results support the hypothesis that listing increases the probability of market enforcement, proxied here with cross-border liabilities. Table 4.4 presents the results of a two-stage least squares (2SLS) regression showing the effect of listing on cross-border liabilities for countries with between 8 and 11 failing recommendations. Model 1 shows the results of the first-stage ordinary least squares (OLS) regression examining the effect of having 10 or more failing recommendations on listing. Model 2 shows the results of a 2SLS analysis of listing on cross-border liabilities without any covariates. Model 3 adds covariates for GDP, inflation, and the real exchange rate.

Listing has a consistently negative and significant effect on cross-border liabilities. In Model 2, listing leads to a 3.6 percent decrease in cross-border liabilities. This is a substantial change – for a listed country like Bolivia, where cross-border liabilities were 871 million at the start of 2010, listing would lead to a decrease of 31.4 million in cross-border bank-to-bank lending. Listed countries with higher initial cross-border liabilities would experience even larger drops. In Model 3, listing leads to a 7.4 percent decrease in bank-to-bank lending. To put this number in context, it is comparable to the decrease in bank flows associated with a 10 percent increase in distance between the capitals of lender and borrower countries.

I code this variable for MONEYVAL countries based on the results of the first MONEYVAL report to be published prior to the creation of the non-complier list.

Both “non-compliant” and “partially compliant” are considered failing ratings.
Table 4.4: Effect of Listing on Cross-Border Liabilities - Model 1 is the results of a first-stage OLS regression estimating the effect of 10+-failing-recommendations on the probability of listing. Models 2 and 3 are the results of 2SLS regression estimating the effect of listing on cross-border liabilities. Standard errors clustered by country, listing period, and the number of failing recommendations.

<table>
<thead>
<tr>
<th>Dependent variable:</th>
<th>Listing</th>
<th>Cross-Border Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>OLS (1)</td>
<td>2SLS (2)</td>
</tr>
<tr>
<td>10+ Failing Recommendations</td>
<td>0.106*** (0.022)</td>
<td></td>
</tr>
<tr>
<td>Listing</td>
<td>-3.961** (1.864)</td>
<td>-7.417*** (2.070)</td>
</tr>
<tr>
<td>GDP</td>
<td>0.201** (0.093)</td>
<td></td>
</tr>
<tr>
<td>Inflation</td>
<td>-0.033 (0.025)</td>
<td></td>
</tr>
<tr>
<td>Real Exchange Rate</td>
<td>-0.008*** (0.001)</td>
<td></td>
</tr>
<tr>
<td>Observations</td>
<td>374</td>
<td>374 276</td>
</tr>
<tr>
<td>Countries</td>
<td>22</td>
<td>22 17</td>
</tr>
<tr>
<td>F Statistic</td>
<td>24.029***</td>
<td>24.029*** 19.26***</td>
</tr>
</tbody>
</table>

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

What do these results tell us about the effect of listing in the larger sample? Based on the regression discontinuity design, the larger sample of listed countries with 10 or 11 failing recommendations probably also experienced a decline in cross-border flows. In some cases, the size of this effect may have been even larger than estimated by the previous analysis. In Turkey, for example, cross-border liabilities declined from 28.8 billion to 18.3 billion during

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39 Similar to trade, distance between countries reduces cross-border bank flows (Buch N.d.; Herrmann and Mihaljek 2010).
Figure 4.3: *Turkey: Cross-Border Liabilities (2009 - 2015)* - The plot shows cross-border liabilities in Turkey from 2009 to 2015. The FATF added Turkey to the non-complier list in February 2010, and moved it up to the enhanced due diligence list (the so-called “blacklist”) in February 2011. Following significant policy change, Turkey was finally removed from the list in June 2014.

the country’s time on the FATF non-complier list. Figure 4.3 shows this trend. While the evidence is descriptive and not causal, it is suggestive of a relationship between the non-complier list and cross-border bank-to-bank lending in Turkey.

### 4.4.1 Placebo Tests

To test the validity of the instrument, I perform several placebo tests. First, I change the threshold, examining the effect of having 11 or more failing recommendations on cross-border flows within a 9-to-12 window of analysis. If 10-failing-recommendations is a valid instrument and introduces a discontinuity into cross-border flows, then a similar discontinuity

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40 Although Turkey was evaluated prior to 2009 and had 10 failing recommendations, I exclude it from my regression discontinuity design because it is an FATF member.
should not be observable with a cut-point of 11 rather than 10. The results of this placebo test support this view. 11-failing-recommendations is not a valid instrument for listing (F-statistic: 4.322) and a 2SLS analysis shows no statistically significant relationship between listing and cross-border flows with this approach. The results of this analysis are available in the appendix.

Second, I examine the effect of being listed on cross-border flows in the period of 2005 to 2008. If the FATF non-complier list is truly driving the change in cross-border liabilities, then being listed in subsequent years (2010 and on) should have no effect on cross-border liabilities in previous years. In contrast, if listing is proxying for an underlying state-specific characteristic, then this omitted variable could have an effect on outcomes even in the period prior to the creation of the non-complier list. I use a 2SLS regression analysis to examine this relationship (relying on 10+-failing-recommendations as an instrument for listing) for the period of 2005 to 2008.\footnote{I omit 2009 because the FATF established its new listing procedures halfway through the year.} Listing has a negative and insignificant effect on cross-border liabilities in this period.\footnote{The estimated coefficient is -3.935 with a standard error of 2.956 and a p-value of 0.18.}

4.4.2 Extending the Analysis to Sovereign Spreads

If my theory is correct, then the FATF non-complier list should lead to different types of market enforcement. I extend my empirical analysis to examine how the FATF non-complier list affects the risk premium on sovereign debt. Because data on sovereign bond spreads is available for only a small number of countries within the 8-to-11 window, I am unable to use the regression discontinuity design for this data set. As a result, this analysis is intended as a plausibility probe establishing a descriptive link between listing and sovereign spreads, rather than as definitive causal evidence.

If international market actors like investment firms allocate resources differently based on FATF non-complier list announcements, these actors are likely to charge a risk premium...
for debt from listed countries. I test this causal mechanism by examining how listing affects perceptions of country risk, proxied with government bond spreads for long-term debt. Bond spreads reflect the gap in interest rates between what investors charge for a particular country’s debt and what investors charge the United States, and are effectively a “risk premium” – when investors view a country as a riskier prospect, they will demand higher relative yields. The yield spread is based on a comparison to the monthly yield for US 10-year bonds.\footnote{The yield spread on bonds ranges from 0 to 17.2 and is highly skewed; for this reason, I add 1 to all values and take the log.}

Economists use a variety of different models to estimate yield spreads, particularly as they pertain to emerging markets. While factors like a country’s economic growth and the size of its debt (relative to its GDP) are generally included in most models, scholars disagree about the relevance of factors like inflation, default history, or democracy.\footnote{See, for example, Eichengreen and Mody (1998), Duffie, Pedersen and Singleton (2003), Mody (2009), and Beaulieu, Cox and Saiegh (2012).} I run three different bond models to estimate yield spreads. My first model includes a dichotomous indicator of listing, as well as variables intended to capture a country’s underlying economic structure and macroeconomic fluctuations. Specifically, I include \textit{GDP Growth}, \textit{Debt-to-GDP Ratio}, \textit{Reserves-to-GDP Ratio}, \textit{Inflation}, and \textit{Real Exchange Rate} (ratio of price level abroad and domestic price level).\footnote{I measure economic growth as the percent change in GDP from year t-1 to year t.} My second model adds \textit{Democracy} (drawn from the Polity IV database). This variable is intended to account for the “democratic advantage” thesis \cite{Schultz and Weingast:2003}, which postulates that democratic regimes possess a credibility advantage over authoritarian counterparts in selling sovereign debt.\footnote{See, for example, North and Weingast (1989), Schultz and Weingast (2003), and Beaulieu, Cox and Saiegh (2012).} My third model adds \textit{Debt-to-Exports Ratio}, which is common in bond models but severely limits the sample due to significant gaps in data availability.
The data for my models is drawn from the IMF’s International Financial Statistics and the Economist Intelligence Unit. The majority of bonds in the data set are denominated in foreign currency. My bond analysis includes 54 countries, 9 of which were listed by the FATF.\footnote{Certain variables, such as debt-to-GDP ratio and debt-to-exports ratio, are only available for a small number of countries; as a result, the sample is limited and does not include all countries that sell debt on the international market.} Although this sample is relatively small, it is important to show that listing has an effect using standard yield spread models, since these variables are the most likely confounders.

I evaluate the effect of listing on bond yield spreads between February 2010 and November 2014, where the unit of observation is country-month. I use an OLS regression with country-fixed effects; as a result, the unit of comparison is within country over time. I also include a time polynomial and lag all explanatory variables by one month to account for the possibility of simultaneity.

Table 4.5 shows the estimated effect of listing on sovereign bond spreads. In line with the theory, investors consider listing an indication of increased country risk, and charge a premium for debt from these countries. Across all three models, listing leads to a statistically significant and substantively large increase in the yield spread. In Model 3, listing increases the yield spread by 27 percent – an effect equivalent in this model to a country’s inflation increasing 12 percent.\footnote{Because the dependent variable in the model is logged, the coefficient is interpreted as the percent change in yield spread, rather than the absolute increase in yield spread.} To provide context for this number, consider a country with a yield spread of 1 percent, which after listing, increases to 1.27 percent. This change in yield spread due to listing is larger than the average historical change for high-quality sovereign debt receiving a credit rating downgrade\footnote{Rudolph-Shabinsky and Shen 2011}.\footnote{48}
<table>
<thead>
<tr>
<th>Dependent variable:</th>
<th>Sovereign Bond Spread</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
</tr>
<tr>
<td>Listing</td>
<td>0.158***</td>
</tr>
<tr>
<td></td>
<td>(0.024)</td>
</tr>
<tr>
<td>GDP Growth (Percent Change)</td>
<td>−0.003</td>
</tr>
<tr>
<td></td>
<td>(0.003)</td>
</tr>
<tr>
<td>Debt-to-GDP Ratio (log)</td>
<td>0.088*</td>
</tr>
<tr>
<td></td>
<td>(0.046)</td>
</tr>
<tr>
<td>Reserves-to-GDP Ratio (log)</td>
<td>0.193*</td>
</tr>
<tr>
<td></td>
<td>(0.100)</td>
</tr>
<tr>
<td>Inflation</td>
<td>0.024***</td>
</tr>
<tr>
<td></td>
<td>(0.003)</td>
</tr>
<tr>
<td>Real Exchange Rate</td>
<td>0.001**</td>
</tr>
<tr>
<td></td>
<td>(0.001)</td>
</tr>
<tr>
<td>Democracy</td>
<td>0.081***</td>
</tr>
<tr>
<td></td>
<td>(0.015)</td>
</tr>
<tr>
<td>Debt-to-Exports Ratio (log)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Observations</td>
<td>1,810</td>
</tr>
</tbody>
</table>

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

Table 4.5: The Effect of Listing on Bond Spreads - Dependent variable is logged spreads on bond yield spreads. OLS regression with country-fixed effects, with standard errors shown in parentheses. All models include a time polynomial (not shown). Monthly observations for February 2010 to November 2014.
4.5 Conclusion: Reputation and Market Punishment

Since the early 2000s, the FATF has published public information about non-compliance. Yet it was not until 2010, when the FATF began issuing its non-complier list, that states began to experience significant reputational consequences for being non-compliant. This chapter provides insight into why reputation is such a powerful mechanism for incentivizing compliance on financial integrity – reputational damage is linked to market enforcement. When the FATF includes countries on its non-complier list, individuals and companies in listed countries suffer financial consequences. Banks delay transactions, refuse to open new accounts, and even close correspondent banking relationships with banks in listed countries. Investors charge a risk premium for sovereign debt from the listed country.

I illustrate these effects through an empirical analysis of how listing has affected cross-border bank-to-bank liabilities and the yield spread on sovereign debt. Using a novel empirical design that exploits an unexpected change in FATF listing procedures, I show that listing leads to a 7.4 percent decrease in international loans to domestic banks. This effect is comparable to the decrease in lending associated with increasing the distance between lending and borrowing countries by 10 percent (Herrmann and Mihaljek 2010). A subsequent analysis suggests listing is also correlated with a 27 percent increase in the yield spread on sovereign debt – an effect larger than the average historical change for a credit rating downgrade (Rudolph-Shabinsky and Shen 2011). Together, these two outcomes indicate that the FATF non-complier list makes it more difficult and costly for domestic actors in listed countries to gain access to capital.

Both types of market enforcement raise the costs of non-compliance for listed countries and increase incentives for policy change. Before the FATF added Panama to its non-complier list in June 2014, domestic financial institutions had few reasons to support more stringent financial transparency regulations. But by December 2015, Panama’s banking sector had lost more than 20 relationships with correspondent banks in the United States (Rindebro)
The significant decline in correspondent banking relationships led Panama’s Minister of Economy and Finance to declare the non-complier list a “threat” to the country’s banking sector and motivated the Panamanian government to pass sweeping reforms. In 18 months, the government improved its criminalization of money laundering and terrorist financing (US Department of State, 2016), established a new framework for freezing terrorist assets (ICRG, 2015), enhanced bank reporting requirements (ICRG, 2017), and improved the capacity of its financial intelligence unit (ICRG, 2017).

The next two chapters further illuminate this process, highlighting the conditions under which the non-complier list improves compliance with FATF standards. Countries have many reasons for failing to comply with FATF standards. Absent market enforcement, the reputational consequences of the FATF non-complier list might still generate policy change in certain countries. But because the FATF relies on market enforcement to intensify reputational damage, the non-complier list has become a powerful tool that incentivizes widespread policy change across states.
Chapter 5

Country Reactions to the FATF List

The Labour Party government and its representatives worked diligently in advance of the issuance of the FATF lists in 2000 and 2001 to ensure that Antigua and Barbuda was in full compliance with required standards before the FATF identified delinquent jurisdictions...Now, under the UPP, we are on a list with Nigeria, Sudan, Ukraine, and Myanmar.

Lester Bird, Leader of the Antigua Labour Party

When the FATF issued its first new-and-improved non-complier list in February 2010, it identified 28 countries that had deficient anti-money laundering or combating the financing of terrorism policies. By placing so many countries directly into public scrutiny, the FATF extended the breadth of its non-compliance efforts beyond any existing endeavors. In subsequent years, it would double the number of listed countries, expanding the non-complier list’s reach until it covered more than a quarter of the countries in the world. Even more interesting than the number of countries, however, was the range of countries listed. Although the highest list was focused on Iran and North Korea, the lowest listing level (the so-called “grey list”) included a variety of states, from important emerging economies like Indonesia, Nigeria, and Turkey, to small island nations like Trinidad and Tobago, and even Least Developed Countries like Sudan and Yemen.

1Quote from a public statement made in February 2010, as cited in Caribarena news 2010.
Given the breadth of the list, many listed countries were immediately sensitive to the possibility of reputational damage. In Antigua and Barbuda, the opposition leader lamented being placed on a list with Nigeria, Sudan, and Myanmar (Caribarena news, 2010). In Turkey, the government worked to pass new legislation on terrorist financing over resistance from opposition leaders, who objected to the government’s far-reaching definition of “terrorism” (Ozbilgin and Burch, 2013). Even in Ecuador, where the president and foreign minister publicly rejected the FATF’s right to “dictate policy,” government officials began to quietly draft a bill to outlaw the financing of terrorism (The Andean Laundry, 2010).

Why do leaders care about the FATF non-complier list? And does the list actually lead countries to change their policies? The theory laid out in Chapter 2 suggests that the FATF’s impact on policy change depends in part on its technocratic nature and its legitimacy as an institution. Because it is widely perceived as a credible and legitimate evaluator of financial integrity policies, when the FATF identifies “high risk” countries through its non-complier list, its actions damage the reputations of listed countries. The FATF intensifies the consequences of reputational damage through markets. Chapter 4 illustrated this process empirically, explaining why the FATF non-complier list signals to banks and investors about the risks of doing business in certain countries and demonstrating how these actors reallocate resources away from non-compliant states.

This chapter explores the consequences of enhanced reputational damage, examining whether the FATF non-complier list actually leads countries to improve compliance with FATF standards.2 As the theory chapter highlights, governments choose a level of compliance by balancing domestic and international considerations. Even when governments select into agreements, institutional commitments can deepen over time, requiring much more costly policy implementation. In the context of global cooperation on financial in-

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2Chapter 6 continues this analysis, exploring under what conditions countries are most likely to change their policies in response to the FATF non-complier list.
tegrity, government efforts to combat money laundering or terrorist financing are often quite controversial domestically.

The FATF non-complier list changes the political calculations of governments by expanding the coalition of domestic supporters. Existing scholarship has highlighted how joining international agreements may empower certain domestic actors. When a state commits to a set of rules, its current government “locks in” future governments to uphold those rules and enhances the credibility of such commitments against opposing political forces (Moravcsik, 2000). International commitments may also alter domestic politics by enabling civil society groups to launch legal challenges and mobilize against non-compliance (Simmons, 2009). Such arguments, however, require a portion of the government or domestic society to be already supportive of the institution’s agenda. In the FATF case, the non-complier list inflicts reputational damage that alters the baseline interests of domestic actors. This process generates new incentives for countries to adopt stronger laws and procedures.

To support this argument, I draw on FATF and government documents, news stories, and interviews with government officials to illustrate the impact of the non-complier list on policy change. Section 2 begins by discussing several reasons why countries fail to change their policies to prevent listing. This analysis reveals how variables like democracy and low government capacity may continue to impede policy change even after listing. I supplement this discussion with qualitative evidence that shows how the non-complier list has been successful at incentivizing policy change across a variety of states. In Section 3, I lay the foundation for my quantitative analysis by discussing some of the empirical challenges of measuring compliance with FATF rules on terrorist financing. I explain how I operationalize policy change in this issue area, and discuss several alternative formulations.

Section 4 discusses my data and empirical approach, which uses a cox proportional hazard model to test whether the non-complier list makes countries more likely to adopt FATF-compliant laws on terrorist financing in a given period. Section 5 presents the results of this
analysis, illustrating that listed countries are 4.9 times more likely to criminalize terrorist financing in a given period. Section 6 tests the most plausible alternative explanation – that bilateral or economic pressure by the United States has driven the adoption of comprehensive laws on terrorist financing. I find no support for this confounder. Section 7 concludes.

5.1 FATF Non-Compliance, Listing, and Policy Change

5.1.1 The Causes of Non-Compliance

The FATF and its affiliate bodies have in-depth, technical monitoring processes that routinely reveal non-compliance, even in G-7 countries. Given the high probability of public scrutiny, it is worth considering the conditions under which countries fail to comply with FATF standards in the first place. Interviews with FATF global network officials suggest that non-compliance tends to be related to three types of problems: a lack of information and capacity, the high costs of policy implementation, and a lack of political will.

For many countries, particularly those that have recently joined one of the FATF regional organizations, a fair amount of non-compliance stems from a lack of information about the FATF and its standards, and a lack of government capacity to meet such standards. Prior to 2001, the FATF global network was relatively small; most of the FATF’s regional-style bodies were created after this date. As a result, many newer members are still familiarizing themselves with the FATF recommendations and learning how to implement them. One of the FATF recommendations, for example, requires countries to establish a financial intelligence unit (FIU) to receive and analyze suspicious transaction reports and other related information. But even when a government creates an FIU, its staff may not really understand how to do their job. One UN official reported providing technical assistance to a country where

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3 FATF Recommendation 20 requires banks and other financial institutions to file suspicious transaction reports if they have grounds to suspect that funds are the proceeds of a criminal activity or related to terrorist financing. Such reports are submitted to the country’s FIU.
the FIU had stacks of unreviewed suspicious transaction reports – FIU officials had no idea what to do with them (Author interview, 8 May 2014)

Among poorer states, non-compliance may also be related to fiscal considerations, as complying with FATF standards can be extremely costly (Author interview with Executive Director of FATF-style regional body, 16 February 2015). The FATF recommendations require governments not only to pass new laws, but also to create and staff a new bureaucratic agency (the FIU), regulate and monitor the financial sector and other financial actors, provide statistics about policy implementation, and improve international cooperation with other countries. Many of these recommendations require significant resources to implement. High levels of compliance are rarely achieved by low-income countries, which often have inadequate budgets to even train bureaucratic staff in this issue area [IMF Legal Department 2011].

Finally, a fair amount of non-compliance can be tied directly to a lack of political will. In some cases, countries may simply not view money laundering or terrorist financing as particularly threatening. For example, small island nations or low-income countries that do not face a significant threat from terrorism might believe such policies are disconnected from their own direct interests. One small island country expressed such a sentiment on the sidelines of the September 2016 Asia-Pacific Group plenary, noting “This is not our priority. There is no threat of terrorist financing. Yet the FATF might blacklist (us) and then suddenly it becomes our priority.”

In larger and more developed countries, governments may encounter a different problem: organized opposition to meeting FATF standards. Many countries have financial sectors that have benefited historically from financial secrecy policies, which allow money launderers and tax evaders to store money anonymously without legal repercussions. In Panama, for example, there was significant political resistance to meeting FATF standards, because the financial industry viewed such measures as potentially cutting into a key source of revenue (Author interview with Executive Director, FATF-style regional body, 16 February 2015).
the Philippines, which was listed as part of the FATF’s old listing process, the Philippine parliament passed a watered-down anti-money laundering law that ignored the FATF’s required 10,000-dollar threshold for reporting suspicious transactions.\footnote{This threshold has subsequently been raised to 15,000 USD/EUR.} Lawmakers perceived that adopting the FATF threshold would be unacceptable for their wealthy colleagues as well as their supporters in the business community (Brillo, 2010a). In both countries, policymakers only adopted the necessary reforms under significant pressure from the FATF.

In the realm of terrorist financing, governments may also encounter political opposition for a different reason: political overreach. Several countries have used legislation criminalizing terrorist financing to suppress their political opponents, while other countries have used different FATF recommendations to justify illiberal behavior. One of the FATF recommendations, for example, focuses on financial scrutiny and regulation of the non-profit sector; this recommendation is sometimes used to justify the suppression of legitimate non-profit and civil society organizations (Hayes, 2013). Governments in several states, including Azerbaijan, Bangladesh, Nigeria, Russia, Sri Lanka, and Turkey, have used this recommendation to justify quashing political opposition (Charity & Security Network, 2013). Given such examples, it is perhaps unsurprising that some leaders encounter strong resistance from civil society to strengthening the implementation of FATF standards.

### 5.1.2 Compliance in the Shadow of Listing

Since the FATF established its 10-failing-recommendation threshold for possible inclusion on the non-complier list, countries have worked hard to avoid falling above this threshold. High-capacity countries, particularly those with extensive anti-money laundering expertise, have sought to pass legislation or adopt reforms during the evaluation process or in the run-up to FATF plenary sessions, in order to prevent possible listing. Indeed, in this dataset, forty percent of FATF-compliant laws passed on terrorist financing between 2010 and 2015.
were passed within a few weeks of an FATF plenary session. High-capacity countries are not only more capable of changing their laws, but are also better at arguing for higher ratings when the reports are adopted in plenary sessions (Author interview with FATF-style regional body official, 27 January 2015).

Once countries fall above the 10-failing-recommendation threshold, relatively few manage to avoid listing because of the short time span between eligibility and public notice. Per FATF bureaucratic procedures, the FATF gives governments a year to demonstrate political will and policy improvements, and potentially avoid listing. In some cases, the FATF may decide not to list a country because it has a small financial sector or poses little threat in terms of terrorist financing or money laundering (FATF-GAFI, 2009). In other cases, governments work hard in advance of the listing process to prevent their countries from being listed. After Monaco learned it was eligible for listing in early 2009, the government adopted and implemented a new law on money laundering and terrorist financing in August of the same year. When the FATF issued its first listing announcement in February 2010, Monaco was not among the listed countries. Similar processes occurred in Liechtenstein and Taiwan. For most countries, however, a year is not enough time to undertake massive policy change and thus listing is unavoidable.

5.1.3 Changing Compliance Calculations

The FATF institutional structure and mutual evaluation process is effective at addressing non-compliance that stems from rule ambiguity or lack of government capacity. The FATF’s organizational structure, whereby FATF and affiliate countries meet 1 to 3 times per year for plenary discussions, encourages information sharing across states. It also helps familiarize countries with the content and interpretation of FATF recommendations. The FATF mon-

5The Executive Director of an FATF-style regional body noted that the FATF negotiates a very tight timeframe for expected policy change with listing-eligible countries, and for most countries, it is impossible to get legislation through in the necessary time (Interview, 30 June 2016).
itoring process is also essential for generating expertise. The FATF and its regional bodies train bureaucrats to serve on evaluation teams, which is an invaluable learning experience for participants. During a country’s year-long evaluation process, the evaluation team meets with dozens of government agencies, as well as the financial sector, improving familiarity with the FATF and its mission. Among these domestic actors, the evaluation process also raises the profile of the domestic anti-money laundering bureaucracy.

The FATF non-complier list intensifies such effects, improving information, focusing governments on specific deficiencies, and empowering advocates of policy change within listed governments. According to officials from the FATF global network, this latter point is particularly important for improving compliance outcomes. The Executive Director of an FATF-style regional body remarked, “The list has had a phenomenal effect on policymakers. If they are listed, they work extremely hard and fast to get off the list. At the government level, we always saw high levels of commitment from the executive but that would slow down once parliament was involved. Now countries move at a much faster pace” (Author interview, 30 June 2016). In some countries, this transformation may occur because the list allows pro-regulation allies to make a more convincing case for policy change. In Ethiopia, for example, the central bank spent several years advocating unsuccessfully for new banking regulations and anti-money laundering controls prior to listing. When the FATF listed Ethiopia in 2010, the central bank had new leverage to push for regulations that would require banks to adopt best practices (Author interview with official from private bank in Ethiopia, 11 February 2016).

The FATF non-complier list also intensifies the negative effects of non-compliance by raising reputational costs. Former FATF President Antonio Gustavo Rodrigues described

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6 This observation is based on comments made by an evaluation team during the September 2016 Asia-Pacific Group plenary meeting.

7 A Thai banking official reported that until Thailand’s 2007 evaluation, few banks were aware of the Thai Anti-Money Laundering Office (AMLO) and its mission, but after the evaluation, the AMLO became well-known because the FATF identified so many problems.
the effectiveness of this “name and shame” process, pointing out that the FATF non-complier list draws the attention of many international organizations “because in the end, everything is connected” (Interview, 29 March 2017). When the FATF lists a country, its reputation is damaged internationally, both within the FATF global network and across other diplomatic contexts. The existence of market enforcement intensifies such effects, raising the costs of reputational damage for non-compliant states.

5.1.4 Descriptive Evidence of Policy Change

Overall, the FATF non-complier list has been an incredibly successful tool at generating compliance. As of February 2017, the FATF had removed 49 of the 61 publicly identified countries from the list after governments made significant reforms to remedy anti-money laundering and combating terrorist financing weaknesses. In most of these cases, governments had to pass and implement new laws, strengthen their regulatory capacities, and improve bureaucratic expertise prior to removal. Not surprisingly, such changes often took multiple years to implement; on average, states remain on the non-complier list for three years. Descriptive statistics suggest that the domestic characteristics of states – in particular, a country’s level of democracy and its government capacity – are correlated with the length of time that a state is listed. Figure 5.1 shows these relationships. On average, higher levels of democracy and lower levels of state capacity (proxied with GDP per capita) correlate with longer listing time.

Countries that change their policies in response to listing fall into three general categories. A handful of countries are “quick compliers” that make policy improvements within a few months of listing. Azerbaijan and Qatar, for example, were listed in February 2010, but by June, both countries had already enacted new laws, issued new regulations for freezing terrorist assets, and addressed all other deficiencies. While the countries’ autocratic political

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8This group of countries includes Azerbaijan, Greece, Honduras, Qatar, and Ukraine.
systems no doubt aided their efforts to pass legislation so quickly, more democratic countries also undertook rapid policy change. Greece, Honduras, and Ukraine all enacted new legislation within six months of listing, and although it took slightly longer for these countries to adopt implementing regulations, all of them were removed from the list in under two years.

Quick compliers are a rarity; most countries take a more incremental approach to policy improvements. For some countries like Argentina, step-by-step policy change occurs due to the extent of deficiencies, which are too numerous to remedy quickly. In other cases, countries adopt an incremental strategy toward policy improvement simply because the bureaucracy moves slowly and needs time to understand and adopt new policies. According to one official from a country that was listed for three years, everyone in the listed country’s government saw policy change as a priority because they “didn’t want to be stuck in the list

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9When the FATF lists a country, they identify a set of deficiencies to be remedied prior to removal from the list. Most countries have three or four deficiencies; Argentina’s initial listing announcement includes eight areas of needed improvement.
for years” (Author interview, 9 February 2016). Nonetheless, policy change took a long time because “it’s hard to build a sustainable level of expertise” to keep up with FATF standards.

A final set of countries are “reluctant compliers” that only implement changes after significant pressure from the FATF. For these countries, the initial pressure of the FATF non-complier list is insufficient to drive policy change. Instead, the FATF must use its higher levels of listing (usually the so-called “blacklist”). Countries like Ecuador, Indonesia, Nigeria, Pakistan, Thailand, and Turkey all ended up on the FATF blacklist after failing to adopt sufficient legislation. In some cases, countries actually tabled legislation in advance of the blacklist, but were unable to find domestic support for passing it. In Turkey, for example, officials from the Ministries of Justice, Interior, and Foreign Affairs worked quickly to draft a new terrorist financing law to align the country more closely with FATF recommendations soon after listing \(10\). The law stalled in parliament, however, due to strong resistance from the opposition party. It was only after the FATF moved Turkey up to the “blacklist” and threatened to suspend its membership that the government eventually passed new legislation.\(^{11}\) In Nigeria, the government passed relevant legislation but did not enact it until the country was put on the blacklist. Even in countries like Ecuador, which was listed for more than five years, the FATF blacklist eventually led the government to undertake significant policy reforms.

5.1.5 Laggard States

The FATF non-complier list has not been universally successful at driving policy change; as of February 2017, a handful of countries remain listed. Upon closer examination, however, many of these countries have undertaken significant reforms. Table 5.1 lists these countries in order of their original listing dates and provides the reasons that they have not yet been

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\(^{10}\) The FATF has four levels of listing, which are discussed in detail in Chapter 3. The FATF’s blacklist is the second highest level of listing. When the FATF lists countries at this level, it calls on its members and affiliates to “consider the risks arising from the deficiencies associated with each jurisdiction.”

\(^{11}\) Turkey was removed from the FATF list in October 2014.
<table>
<thead>
<tr>
<th>Country</th>
<th>Listed</th>
<th>Reason for Continued Listing</th>
</tr>
</thead>
<tbody>
<tr>
<td>North Korea</td>
<td>2007</td>
<td>Non-Cooperative</td>
</tr>
<tr>
<td>Iran</td>
<td>2007</td>
<td>Newly Cooperative</td>
</tr>
<tr>
<td>Syria</td>
<td>2010</td>
<td>No Site Visit</td>
</tr>
<tr>
<td>Yemen</td>
<td>2010</td>
<td>No Site Visit</td>
</tr>
<tr>
<td>Afghanistan</td>
<td>2012</td>
<td>No Site Visit</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>2013</td>
<td>No Site Visit</td>
</tr>
<tr>
<td>Iraq</td>
<td>2013</td>
<td>Implementing Action Plan</td>
</tr>
<tr>
<td>Uganda</td>
<td>2014</td>
<td>Implementing Action Plan</td>
</tr>
<tr>
<td>Bosnia-Herzegovina</td>
<td>2015</td>
<td>Implementing Action Plan</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>2016</td>
<td>Implementing Action Plan</td>
</tr>
<tr>
<td>Ethiopia*</td>
<td>2017</td>
<td>Implementing Action Plan</td>
</tr>
</tbody>
</table>

Table 5.1: *Countries on the FATF List (as of Feb 2017)* - Table shows the countries included on the non-complier list, the year of listing, and the reason the country has not yet been removed from the list. Ethiopia was previously listed by the FATF from 2010 to 2014; the FATF re-listed it in February 2017 due to the results of its fifth-round mutual evaluation report.

removed from the list. All of the listed countries (with the exception of North Korea) have taken measures to cooperate with the FATF and to implement their FATF action plans. Indeed, four of the countries – Syria, Yemen, Afghanistan, and Lao PDR – have fulfilled their FATF commitments but have not been removed from the list because the FATF has yet to conduct on-site visits. Overall, the list appears quite effective at incentivizing policy change, even among the least cooperative of states.

### 5.2 Observing Policy Change on Financial Integrity

In order to analyze whether an institution like the FATF has an independent effect on state policy, it is necessary to establish first a clear counterfactual: what would state policies look like absent any institutional guidance and monitoring? As [Martin (2011)] points out, measuring institutional effectiveness by focusing exclusively on “compliance” could be misleading – countries may comply with international rules even prior to joining an international agreement, and conversely, institutions may have a big impact on state behavior.
but countries might still fall short of full compliance. However, in terms of examining the effect of the FATF on state policy, compliance is substantively meaningful – when countries adopt laws that are not in line with FATF standards, they are choosing less effective and impactful policies. With these challenges in mind, this section offers a precise definition and operationalization of policy change, and also discusses several alternative formulations.

Although the FATF issues 40 recommendations\textsuperscript{12} I focus on one specific indicator of compliance: the criminalization of terrorist financing. The FATF considers the criminalization of terrorist financing to be a top priority and one of the six building blocks of the financial integrity regime\textsuperscript{13} Compliance with this recommendation is a clear indication of policy change. The FATF did not adopt the criminalization of terrorist financing as a recommendation until 2001, and prior to that time, only a handful of states had laws criminalizing terrorist financing.\textsuperscript{14}

### 5.2.1 Concept and Operationalization

Policy change occurs when a country adopts laws or regulations that are tangibly different from existing laws and regulations. With this basic definition, policy change could, in theory, be either a deepening or a weakening of legislation – a country deciding to repeal its laws or remove regulation would still be engaging in policy change. Indeed, this challenge has led some to argue that observed compliance may actually be due to selection bias, rather than an independent effect of the institution on state behavior (Downs, Rocke and Barsoom, 1996; Von Stein, 2005). Within the realm of terrorist financing, however, most policy change

\textsuperscript{12}This study covers the FATF’s third round of mutual evaluations, during which the FATF actually issued 49 recommendations. In advance of its fourth round of evaluations (currently ongoing), the FATF consolidated its recommendations to 40.

\textsuperscript{13}One official from an FATF-style regional affiliate went so far as to say that without the top six recommendations, “anything else would be pointless” (Author interview, 27 January 2015).

\textsuperscript{14}This variable is, at best, a partial measure of compliance; legal and institutional changes cannot address whether countries are actually implementing key policies, as is clearly demonstrated by Findley, Nielson and Sharan (2014). Similarly, legal compliance and even policy implementation cannot prove that the institution has reduced money laundering or terrorist financing. While these are important issues, they are outside the scope of this study.
has been unidirectional – countries adopt laws on terrorist financing and expand them over time, but to-date, no country has repealed its laws. As such, the concept of policy change in this context is one of policy deepening, where countries adopt more stringent or expansive regulations. Moreover, because the goal of this chapter is to examine the effect of the FATF non-complier list on state policy, policy change can be further specified as occurring when a country deepens or expands its laws in line with FATF standards.

Within the regime to combat terrorist financing, significant policy change has taken place over the last twenty years – the UN General Assembly adopted the International Convention for the Suppression of the Financing of Terrorism in 1999, the UN Security Council passed a resolution on terrorist financing in 2001, and the FATF adopted recommendations on terrorist financing in the same year. While all of these institutions have rules on terrorist financing, the rules differ in important ways. As can be seen in Table 5.2, FATF Special Recommendation II, which requires countries to create a standalone terrorist financing offense, is much more detailed than the Convention or the Security Council resolution. Specifically, the FATF recommendation requires countries to criminalize not only the financing of terrorist acts but also terrorist individuals and organizations – key modifications since funds are fungible. Such differences are meaningful from an effectiveness standpoint because the majority of terrorist financing is used for broad organizational support, such as recruitment, training, subsistence, and travel (FATF-GAFI, 2008).

Given these differences, I operationalize policy change by collecting and coding data on when countries adopt FATF-compliant laws on terrorist financing. For the small subset of countries that adopted fully compliant laws early on, this information is available through the FATF third-round mutual evaluation reports. For the majority of countries, I consult

15The FATF originally formulated its recommendations on terrorist financing as separate “Special Recommendations.” In 2012, the FATF revised its standards and integrated recommendations on terrorist financing and money laundering. Special Recommendation II, as I refer to it in this chapter, is now FATF Recommendation 5.

16I validate this coding using the results of the FATF’s Terrorist Financing Fact-Finding Initiative (TFFFI). Countries are only coded as compliant if the FATF mutual evaluation report and the TFFFI report align.
<table>
<thead>
<tr>
<th>Institution</th>
<th>Year</th>
<th>Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>UN Convention for the Suppression of the Financing of Terrorism</td>
<td>1999</td>
<td>Criminalize the provision or collection of funds with intention or knowledge that they are to be used, in full or in part, to carry out an act defined in annex or intended to cause death or serious bodily injury to a civilian</td>
</tr>
<tr>
<td>UN Security Council Resolution 1373</td>
<td>2001</td>
<td>Criminalize the provision or collection of funds with intention or knowledge that they are to be used to carry out terrorist acts.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Prohibit persons from making funds/resources available for benefit of persons who commit/facilitate/participate in terrorist act.</td>
</tr>
<tr>
<td>FATF Special Recommendation II on Terrorist Financing</td>
<td>2001</td>
<td>Criminalize the provision or collection of funds with intention or knowledge that they are to be used to (a) carry out a terrorist act, (b) by a terrorist organization, or (c) by an individual terrorist.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Funds do not have be used to carry out/attempt terrorist act or be linked to terrorist act.</td>
</tr>
</tbody>
</table>

Table 5.2: *International Standards on Criminalization of Terrorist Financing* - The table compares international standards for the criminalization of terrorist financing across three institutions. Note that unlike the UN Convention and UNSCR 1373, the FATF standards require countries to criminalize the provision of funds for terrorist organizations and individuals, regardless of whether funds are linked to a terrorist act.

FATF reporting, news articles, and legal text to code the month and year when a country adopts a law that defines the offense of terrorist financing in line with the FATF definition, laid out in Section 5.2 of the FATF methodology document. Compliant laws fulfill five specific criteria, criminalizing:

1. The collection of funds by any means, directly or indirectly;

2. With the intention or knowledge that funds should be used, in full or in part, to:

17 In cases where I could not find the date of adoption, I use the month and year that legislation entered into force.
3. Carry out a terrorist act(s), defined to include all relevant Conventions\(^{18}\)

4. By a terrorist organization;

5. By a terrorist individual.

5.2.2 Alternative Measures of Policy Change

There are several alternative ways to measure the FATF non-complier list’s effect on terrorist financing policies. A weaker measure of compliance might be to examine whether a country has adopted any law on terrorist financing. This approach could be justified by time trends – most countries did not have laws on terrorist financing prior to 9/11, and therefore the most significant policy change is the decision to create a standalone terrorist financing offense. There are, however, several problems with such a formulation. First, the Convention on the Suppression of the Financing of Terrorism, the UN Security Council, and the FATF all require states to criminalize terrorist financing; therefore the simple act of criminalization is unlikely to be a meaningful measure of the FATF’s impact on state policy. Second, more than 60 percent of countries had already adopted some kind of law on terrorist financing prior to the FATF’s first listing announcement in February 2010, so this dependent variable would severely limit the sample size of the analysis. Finally, as discussed earlier, gaps in terrorist financing legislation are substantively meaningful – all terrorist financing laws are not of equal significance.

Alternatively, a stronger measure of policy change might capture not just legal or regulatory change but also differences in policy implementation. Instead of just considering the

date of adoption of new FATF-compliant laws, for example, an empirical analysis could examine indicators of implementation such as the number of law enforcement cases related to terrorist financing, or changes in the number of prosecutions and convictions for this crime. Unfortunately, such data is not available on an aggregate scale, so such measures cannot be the primary dependent variable for a cross-country, panel analysis.

5.3 Analyzing Policy Change on Terrorist Financing

My analysis examines how the FATF non-complier list affects the length of time that it takes for a country to adopt an FATF-compliant law on terrorist financing. I begin the analysis in February 2010 because that is start of the current non-complier list, and my data goes through December 2015. My unit of observation is the country-month. Data on country listing status is drawn from FATF non-complier list announcements (published online in February, June, and October every year).

I test my theory using a Cox Proportional Hazards model, which analyzes how variables affect the length of time in months it takes for a country to criminalize terrorist financing in line with the FATF recommendation. This model is appropriate given the unidirectional nature of the data – once a country has fully criminalized terrorist financing, it is unlikely to repeal its law. Due to this approach, however, countries that criminalized terrorist financing in line with FATF guidelines prior to February 2010 are excluded from the analysis.

My simplest model includes data for 141 countries, including 48 of the 57 countries listed between February 2010 and December 2015 as part of the non-complier list. As I add covariates, the sample drops to 134 countries (44 listed) and 106 (37 listed). My unit of observation is country-month. In the simplest model, this equates to 7789 observations and 79 events (instances where a country criminalizes terrorist financing in line with FATF guidelines), while the most comprehensive model includes 5178 observations and 46 events.\footnote{The results are robust to running all three models on this smallest sample.}
5.3.1 Dependent Variable: Policy Change on Terrorist Financing

My dependent variable is a dichotomous indicator of whether a country has adopted an FATF-compliant law on terrorist financing in a given month and year. As discussed earlier, this is a clear indication of policy change since all countries in the analysis have, as of February 2010, not yet adopted FATF-compliant legislation on this matter. To determine whether a country has criminalized terrorist financing in line with FATF guidelines, I collected data on the month and year in which each country adopted legislation that fulfilled all of the FATF requirements on criminalizing terrorist financing. In my coding, for a law to be considered FATF-compliant, it has to extend to any person who willfully provides or collects funds with the intention or knowledge that they are to be used to carry out a terrorist attack, by a terrorist organization, or by an individual terrorist.\(^{20}\)

Figure 5.2 shows the distribution of this variable over time, separated by whether a country is eventually included on the non-complier list (red dashed line) or has never been part of the non-complier list (black solid line). As of late 2008, most countries had not adopted FATF-compliant laws on terrorist financing. Instead, many countries had partial laws that criminalized terrorist financing only when linked to a terrorist act (FATF-GAFI, 2015). Such gaps might seem minor, but substantively, they are quite meaningful – funds are transferrable, and while terrorist organizations need relatively little money to mount an attack, they often require significant resources to sustain recruitment, propaganda, and legitimation activities (FATF-GAFI, 2008a). Non-compliance may also arise when countries adopt a too-narrow definition of terrorism, failing to cover all of the conventions on terrorism as required by the FATF.

Since the FATF adopted new non-complier list procedures in 2009, countries have been significantly more likely to adopt laws on terrorist financing that meet FATF standards. Interestingly, as of 2015, close to 90 percent of listed and formerly listed countries had

\(^{20}\)This language is in line with section 2 of the FATF Interpretive Note to Recommendation 5 (Terrorist Financing Offence) (FATF-GAFI, 2012).
Figure 5.2: The figure shows the percent of never-listed countries (solid black line) and listed post-2009 countries (red dashed line) that have adopted FATF-compliant laws on terrorist financing (data are monthly). The dotted vertical line indicates the 2009 announcement of the revamped FATF non-complier process that issued its first non-complier list in February 2010.

FATF-compliant laws, whereas only about 50 percent of non-listed countries had similarly compliant laws. This significant policy change by listed countries is the reason that the FATF has removed so many countries from listing – as of February 2017, 49 listed countries have “graduated” from the non-complier list following major improvements in their laws.

5.3.2 Independent Variables

If the non-complier list incentivizes policy change in states, then listed states should be more likely to pass laws criminalizing terrorist financing. As such, the independent variable of interest is whether, at a given point in time, a country is on one of the non-complier lists. I operationalize this variable in two ways. First, I create a dichotomous variable *Listing*, which

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21 Appendix A.2 provides a list of all countries listed as part of the non-complier list, listing dates, and graduation dates (where applicable).

135
indicates whether a country is on the non-complier list at any level (grey, dark grey, or black) in a given month. Operationalizing listing as a dichotomous measure makes sense in part because the nuance of different levels of listing is often lost in media coverage. Ukraine and Argentina, for example, were only on the grey list, yet when Ukraine was removed from the FATF monitoring process, the *Wall Street Journal* headline read “FATF Removes Ukraine from Blacklist, Updates on Argentina” (Rubenfeld, 2011). In the dichotomous coding, the variable is equal to 1 if a country is listed at any level and 0 otherwise. In the largest version of the data, approximately 17 percent of observations are coded as 1’s.

The effect of listing, however, might also depend on the specific level of listing; therefore, I also operationalize the non-complier list as an ordinal variable *Listing Strength*. This variable ranges from 0 (no list) to 3 (enhanced due diligence). When the data is differentiated in this way, 12 percent of observations are on the “grey” list, 1 percent of observations are on the “dark grey” list, and 4 percent of observations are on the “black” list.

### 5.3.3 Confounders

My empirical analysis includes control variables likely to influence both the probability that a country is listed and its compliance with FATF recommendations.

#### Non-Complier List Selection Criteria

The FATF has articulated very clear guidelines for the non-complier list. As discussed earlier, the FATF builds a pool of potential listed countries based on the following criteria:

- (a) country receives 10 or more failing ratings on the 16 most important recommendations;

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22The FATF has called for counter-measures against only two countries: Iran and North Korea. I exclude these countries from my analysis because there is no available information about terrorist financing laws in these countries during this time period. I also make this choice because the US government and the UN Security Council had significant sanctions in place against both countries during this time period. For this reason, it would be difficult to isolate the effect of the FATF list compared to other mechanisms.

23This variable would go up to 4 for counter-measures but because I drop Iran and North Korea from the analysis (due to a lack of information about terrorist financing laws), it stops at 3.
• (b) country fails to participate in the FATF or a regional affiliate and its concomitant evaluation process; or,

• (c) country is nominated by the FATF or a regional affiliate for listing consideration (FATF-GAFI, 2009).

To account for this selection process, I include 10+ Failing Recs, an indicator of whether a country received 10 or more failing ratings on the 16 most important recommendations in its third-round mutual evaluation report. In general, the FATF and its regional bodies only evaluate a country once per cycle, so for most countries, the number of failing recommendations does not change across the data set. Because even the possibility of being included on the non-complier list is likely to drive policy change, the underlying baseline rate of adoption for countries with 10 or more failing recommendations is likely to be different from the baseline rate of adoption for countries with less than 10 failing recommendations (which do not face the threat of listing). For this reason, I model 10+-failing-recommendations as a distinct stratum rather than a control variable.

A country’s direct ties to the FATF may also affect how quickly it meets FATF standards on the criminalization of terrorist financing. I include the variable FATF Member to account for whether a country is a member of the FATF in a given year. I do not include a control for listing nomination; according to an interview with an FATF regional body Executive Director, only one country has ever been nominated for listing consideration (Author interview, 30 June 2016).

**Listing Criteria**

24 Countries belonging to the Council of Europe’s MONEYVAL are a notable exception to this trend.

25 Log-rank tests comparing the time to criminalize terrorist financing for countries with 10 or more failing recommendations and countries with 9 or fewer failing recommendations confirm that stratification is appropriate.

26 Because almost all of the countries in the sample are members of FATF-style regional bodies, I do not include membership in the FATF global network as a control.
Once countries enter into the pool of possible listed countries, the FATF makes decisions about whether to list on the basis of several factors.\footnote{Additional factors not included in my model include the risk of money laundering or terrorist financing, not adequately responding to requests for international cooperation, and the degree to which the country has demonstrated a willingness to address its deficiencies \cite{FATF-GAFI2009b}.} One key determinant is the size of a country’s financial sector – in particular, the percentage and total assets held in non-resident accounts \cite{FATF-GAFI2009b}. As a proxy for this factor, I include \textit{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 investment, other investment, and reserve assets.\footnote{For more on this measure, please see \url{https://www.imf.org/external/np/sta/bop/BOPman.pdf}.} In 2015, Germany had the largest positive net financial account of any country in the data set (324 billion US dollars) and Brazil had the largest negative value (-100 billion US dollars). Because large positive or negative values equate to larger financial sectors, I take the absolute value of this variable, and then log it to address the highly skewed distribution.

Countries may also be listed by the FATF if they fail to criminalize money laundering or terrorist financing. For this reason, I include \textit{Previous Terrorist Financing Law}, a variable that indicates whether a country had some type of law on terrorist financing as of the end of 2009 (two months before the start of the non-complier list). Since my design requires excluding all countries that had FATF-compliant laws on terrorist financing as of February 2010, this variable is coded 1 if a country has taken steps to criminalize terrorist financing but the existing legal framework is insufficient. Of the 141 countries included in the analysis, 96 (68 percent) had adopted some type of law by the end of 2009.

\textbf{Policy Diffusion}

The diffusion of FATF-compliant laws across regions is also likely to influence the speed at which countries adopt comprehensive laws on terrorist financing. International policy diffusion – a process that occurs when a government’s policy decisions are affected by the
previous policy choices of other countries – has been shown to affect democratization (Gleditsch and Ward, 2006), bilateral investment treaties (Elkins, Guzman and Simmons, 2006), liberal economic policies (Simmons and Elkins, 2004), and anti-money laundering policies (Sharman, 2008). The FATF organizational structure is likely to promote diffusion through learning and emulation. Most members of the FATF global network do not belong to the FATF, but rather to an FATF-style regional body. Regional organizations monitor the implementation of FATF standards in member countries, provide technical assistance, and promote capacity building among domestic bureaucrats. Additionally, such bodies are also likely to socialize countries into valuing financial integrity.

I account for the possibility that states may comply faster if their peers have already complied with the variable Diffusion. This variable ranges from 0 to 1 and for each country, represents the percentage of member states in the country’s FATF regional affiliate that have adopted FATF-compliant laws on terrorist financing. Germany, for example, is an FATF member, so for Germany, this variable represents the percentage of all FATF countries with compliant laws at a given point in time. Thailand is a member of the Asia/Pacific Group on Money Laundering (APG), an FATF regional body, so for Thailand, diffusion is the percentage of all APG members with compliant laws in a particular month.

5.4 Results: Listing Drives Policy Change

The results provide strong support for the hypothesis that the non-complier list drives policy change on terrorist financing. When the FATF places countries on the non-complier list, these countries adopt FATF-compliant laws on terrorist financing more quickly than their
non-listed counterparts. Table 5.3 shows the effect of listing on the time it takes for a country to criminalize terrorist financing in line with FATF standards. Model 1 tests the effect of listing on criminalization, and includes control variables that are likely to affect the FATF’s decision about whether or not to include a country on the non-complier list. Model 2 tests the effect of listing with an additional control for financial account, and Model 3 adds controls for capacity, democracy, and terrorism risk.

Across all three models, listing has a positive and significant effect on compliance, increasing the likelihood that countries criminalize terrorist financing. In the full model (Model 3), listed countries are 4.9 times as likely to criminalize terrorist financing in line with FATF standards compared to countries that are not on the non-complier list (p-value: <0.001). Policy diffusion also has a consistently strong and positive effect, suggesting that as more states within a country’s regional FATF affiliate organization criminalize terrorist financing, states that have yet to pass FATF-compliant laws are increasingly likely to adopt new laws in line with FATF standards. In the full model, financial account, which proxies for the size of a country’s financial sector, also has a positive effect. This suggests that a country’s financial characteristics are an important determinant of whether it changes its policies quickly in response to listing.

Figures 5.3 and 5.4 plot the hazard curves and 95 percent confidence intervals for non-listed and listed countries, based on Model 3 in Table 5.3. For both figures, the hazard curves represent the probability that a country still has a non-compliant law on terrorist financing over the 5 year period after the FATF issues its first non-complier list announcement in February 2010. Both hazard curves show the probability of non-compliance for non-US ally countries with 10 or more failing recommendations. All other variables except listing are set at the means.
### Table 5.3: Listing and Criminalization: Cox Proportional Hazards Models - Hazard ratios for cox proportional hazards models. Values over 1 indicate a positive effect; values below 1 indicate a negative effect. Standard errors are clustered by country and shown in parentheses. All models stratified by 10+ Failing Recs; Model 3 is also stratified by US Ally.

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<tr>
<td>Events</td>
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<td>50</td>
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</tbody>
</table>

Note: *p<0.1; **p<0.05; ***p<0.01
5.5 The Role of US Power

US diplomatic and economic power is the most likely confounder for my analysis. The United States is a global leader on combating money laundering and terrorist financing, and devotes significant resources to providing technical assistance to states worldwide. Furthermore, existing scholarship suggests US economic power has contributed to the diffusion of regulatory standards in other areas of global finance (Simmons 2001, Drezner 2007, Posner 2009). The United States could drive states directly to change their policies on terrorist financing through bilateral pressure or economic coercion. I probe these possibilities through regression analyses that add additional US-centric controls.

The US government has several different types of tools that it uses to deal with states that pose a significant risk of money laundering or terrorist financing. Perhaps its most powerful tool is the 311 Special Measures list. Since 2001, the US Secretary of Treasury has had the authority to designate foreign jurisdictions, institutions, types of accounts, and classes of transactions as “primary money laundering concerns” under Section 311 of the

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32For example, the US Department of Treasury’s Office of Technical Assistance has close to 100 projects that are designed to develop strong financial sectors across various issue areas, including tax administration, budget execution, debt management, financial sector supervision, and anti-corruption. For more information, see https://www.treasury.gov/about/organizational-structure/offices/Pages/Technical-Assistance-.aspx.
USA PATRIOT Act. When the US Treasury adds a country or institution to the 311 Special Measures list, US financial institutions and agencies are required to take special measures against designated entities. Special measures include additional record keeping requirements, steps to determine account ownership, and customer identification measures. In some cases, financial institutions may even be prohibited from forming any type of banking relationship with financial institutions or countries on the 311 list. The 311 list can inflict significant damage on listed entities and has been known to drive policy change. The US Treasury first used this power in December 2002, in response to a call by the FATF to impose “countermeasures” on Nauru. Within days, offshore banks registered in Nauru began to close and the Nauruan government adopted new legislation to address its shortcomings (Zarate 2013, 153).

I probe whether the 311 Special Measures list has independently driven countries to change their policies on terrorist financing by collecting data on all Special Measures listings to date. As of June 2017, the Treasury has listed 20 banks and 5 countries under this process. I create a dichotomous variable US - 311 Special Measures List that indicates whether a country’s institution or the country itself was on the 311 Special Measures list between February 2010 and December 2015 in a given month. Approximately 2 percent of observations are coded as 1’s in the dataset.

A second possibility is that listed countries might change their policies in response to the FATF non-complier list because they view FATF listing as correlated with US unilateral sanctions. In this scenario, the US government might levy sanctions against FATF non-complier list countries, either immediately after listing or if countries do not change their policies in a sufficient amount of time. Probing this possibility empirically is challenging because if listed countries anticipate the possibility of unilateral action by the United States,
they may be inclined to change their policies before the US government levies unilateral sanctions. If this causal process is correct, however, we would expect at a minimum to see the US government take some action against states that remain on the non-complier list for several years, and for US government sanctions to have some effect on policy change.

I probe the causal effect of US unilateral sanctions by collecting data on all countries that were subject to US government sanctions between February 2010 and December 2015. Data is drawn from the US Department of Treasury’s list of active sanctions programs. As of June 2017, the US Treasury had targeted or comprehensive sanctions against 19 countries. I create a dichotomous variable US - Sanctions List that indicates whether the US government had targeted or comprehensive sanctions against a country in a given month. In the data set, approximately 7 percent of observations are coded as 1’s.

The US government might also pressure countries bilaterally to change its policies. The US State Department could raise FATF compliance during bilateral meetings, or encourage foreign partners to seek technical assistance from the United States or various international organizations. I proxy US bilateral pressure with data from the US State Department’s annual International Narcotics Control Strategy Report (INCSR). Each year, this report summarizes money laundering and terrorist financing policies across most countries in the world. The report also prioritizes countries using a three-tier classification system. “Jurisdictions of Primary Concern” are major money laundering countries where financial institutions “engage in transactions involving significant amounts of proceeds from all serious crimes” or where financial institutions are vulnerable because of weak supervisory or enforcement regimes. I create an ordinal variable US - State Dept List that indicates each country’s assigned INCSR tier, where 1 indicates a country is of low concern and 3 indicates a coun-

35This list is available at: https://www.treasury.gov/resource-center/sanctions/Programs/Pages/Programs.aspx.

36The US government levies two types of sanctions against foreign countries. Comprehensive sanctions involve broad bans on trade and economic exchange with a particular country, while targeted sanctions block a selection of assets or trade within a country.

37For more on this definition, see: https://www.state.gov/j/inl/rls/nrcrpt/2016/vol2/253367.htm.
try is categorized as a “Jurisdiction of Primary Concern” in a given year. In the data, approximately 32 percent of observations are coded as 3’s.

Table 5.4 shows the results of regressions examining the effect of listing on the time to criminalization while controlling for US influence. Model 1 shows the effect of listing on criminalization while controlling for whether a country is on the 311 Special Measures list. Model 2 controls for US government sanctions. Model 3 controls for US bilateral pressure, proxied by the State Department’s INCSR list. Model 4 aggregates these separate lists into a measure indicating whether a country is included on any of the US government lists in a given month. Across all four specifications, listing continues to have a positive and statistically significant effect on time to criminalization.

5.6 Conclusion: Listing Changes Compliance Costs

The evidence in this chapter provides strong support for the hypothesis developed in Chapter 2: when the FATF includes countries on its non-complier list, these countries will be quicker to pass legislation and implement new regulations to comply with FATF standards. Qualitative evidence reveals three main reasons why countries fail to comply with FATF recommendations: lack of information and capacity, high costs of policy implementation, and lack of political will. The FATF’s organizational structure and in-depth monitoring and assessment process are effective at addressing this first stumbling block: plenary meetings encourage familiarity with FATF recommendations, and year-long country reviews reduce ambiguity and build technical expertise in bureaucracies. But when compliance is costly from an economic or political standpoint, the FATF needs to rely on its non-complier list to incentivize policy change.

By publicly identifying non-compliant countries, the FATF changes the cost calculations of governments in non-compliant states. In this chapter, I have focused on two direct ways that the FATF list affects domestic incentives. First, it raises the profile of financial in-
tegrity, providing additional leverage for bureaucratic or political supporters who want to strengthen the anti-money laundering regime. Second, it intensifies the reputational costs of non-compliance – most bureaucrats and countries want clean reputations internationally. Empirical analysis supports these findings; listed countries are almost five times more likely to adopt FATF-compliant laws on terrorist financing as non-listed countries.

A closer examination of listed countries, however, indicates that these two mechanisms are insufficient for explaining widespread change in such a short amount of time. In countries with competing political priorities or strong domestic opposition, governments are unlikely to prioritize compliance based simply on a strengthened bureaucracy or increased reputational costs. Instead, it is the process of market enforcement that generates policy change. The next chapter will test this interaction between listing and market enforcement, illustrating how the effect of the non-complier list is moderated by market integration. Quantitative and qualitative analysis will examine under what conditions the FATF non-complier list is most effective at driving policy change, and will highlight specific causal pathways that underlie this process.
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| Observations            | 4,634   | 4,634   | 4,610   | 4,634   |
| Countries               | 88      | 88      | 88      | 88      |
| Events                  | 50      | 50      | 50      | 50      |


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Chapter 6

Markets as Moderators for Policy Change

*Governments are used to being named and shamed, but when something hurts the pockets of bankers, they’re usually more sensitive to requests.*

UNODC official, describing the FATF’s impact on governments.\(^1\)

Since February 2010, more than 50 listed countries have changed their policies and been removed from the FATF non-complier list. In public statements, the majority of these countries directly tie the passage of new legislation to the FATF. In the Philippines, for example, the parliament adopted incremental improvements to its anti-money laundering and combating terrorist financing framework, which the Senate President justified by noting that the parliament could always make additional changes if the FATF deemed the amendments inadequate (dela Cruz 2013). In Panama, the president and legislature solicited advice from the FATF prior to passing laws on illegal financial activities, directly tying such legislative action to the implementation of the country’s FATF action plan (Rodriguez 2015). Across many different types of states, irrespective of regime type or government capacity, the FATF non-complier list has been successful at incentivizing policy change.

\(^1\)Author interview, 8 May 2014
Why is the FATF list so effective? And under what conditions are countries most likely to change their laws in response to the FATF non-complier list? In Chapter 2, I argue that when international organizations are widely perceived as credible and legitimate, their monitoring reports are more likely to generate reputational consequences for non-compliant states. But reputational damage alone is often insufficient to motivate policy change. Instead, the ultimate impact of institutional monitoring on compliance will depend on the degree to which an international organization’s reporting increases the costs of non-compliance. International organizations themselves are rarely able to levy significant penalties for non-compliance. When institutional monitoring is credible and legitimate, however, it can reduce informational uncertainty for third parties interested in learning about non-compliant behavior. When these third-party actors are banks or investors, institutional monitoring can generate market enforcement, whereby market actors reallocate resources away from non-compliant states.

The FATF non-complier list affects state policies on terrorist financing through such a process. While the FATF list has had an impact on policy change across a variety of states, this chapter will show that market integration has intensified the list’s effect on compliance. In chapter 4, I showed that banks and investors use the the non-complier list to reevaluate country risk. When the FATF lists a country, banks and investors penalize it financially by reallocating resources away from the non-compliant state. Chapter 5 illustrated how the non-complier list leads to significant policy change across states. This chapter builds on these earlier analyses by testing the specific causal mechanism developed in my theory, i.e. whether market integration intensifies the impact of listing on compliance. My analysis shows that the non-complier list has the strongest effect on highly market-integrated countries. After two years on the non-complier list, high market integration countries are 50 percent more
likely to adopt FATF-compliant laws on terrorist financing in a given period than low market integration countries.\footnote{Based on a comparison of a country with cross-border bank liabilities that are one standard deviation above the mean and a country with cross-border bank liabilities that are one standard deviation below the mean.}

This chapter proceeds as follows. Section 2 draws from interviews of government and private sector officials in formerly listed countries, as well as news reports and international organization documents, to identify several different ways that the impact of the FATF non-complier list on compliance is moderated through market integration. Section 3 discusses the concept of market integration and its operationalization. I proxy market integration with cross-border bank liabilities, which indicate the amount of money that domestic banks in a particular country owe to international banks. Section 4 builds on the analysis in Chapter 5, relying on the same data set and a cox proportional hazards model approach to test cross-nationally how markets moderate the effect of listing on policy change. Section 5 illustrates the specific causal process of market enforcement in Thailand, which was listed from February 2010 to June 2013. Section 6 concludes.

### 6.1 Markets as Moderators

Prior to the creation of the FATF non-complier list, FATF monitoring had a very limited effect on the reputations of non-compliant states. The FATF’s primary monitoring and assessment mechanism is its mutual evaluation process, where a team of bureaucrats from the FATF and peer countries spend a year evaluating a country’s compliance with the FATF recommendations. The evaluation process helps build the capacity of evaluated countries by clarifying FATF obligations, providing tangible suggestions and areas of improvement, and facilitating the provision of technical assistance. The reputational consequences of the final report, however, are fairly limited. Reports do not aggregate compliance scores, nor do they
include overall compliance ratings. Moreover, the FATF adopts different country reports each year, which makes it challenging to compare the levels of compliance across countries.

When the FATF supplemented this evaluation process with the new non-complier list in 2010, the reputational consequences of non-compliance intensified. Poor compliers now faced the prospect of being put on a “blacklist” that included unsavory states like Sudan and Yemen. More importantly, however, the non-complier list created the possibility of market punishment. International banks integrate the non-complier list into their risk models, which they use to evaluate the costs and benefits of doing business with customers in different jurisdictions. Banks may restrict business, charge higher premiums for transactions, or, in some cases, terminate a relationship with banks or entities in listed countries. International investors may also engage in market enforcement, interpreting a government’s non-compliance as a negative signal about its ability or willingness to repay debt obligations. In both of these scenarios, the existence of market enforcement creates pro-compliance domestic allies who are influential in pressuring governments to change their policies.

6.1.1 “Hurting the Pockets of Bankers”

Perhaps the most effective way that the FATF non-complier list raises the costs of continued non-compliance is through market enforcement from banks. As discussed in greater detail in Chapter 4, most countries have laws – based on FATF standards – that require banks to evaluate potential customers partly on the risk of money laundering or terrorist financing. Banks assess such risks by considering the customer’s country of origin and its associated risks. As a result, the FATF has a ready audience for its non-complier list: the international banking community.

A substantial body of evidence suggests that international banks around the world have integrated the non-complier list into their risk calculations about doing business with banks or clients in listed countries. Most large banks maintain complex risk models to assess the
risk of doing business with different countries. When the FATF lists a country, “it can cause a recalibration of the risk model, leading to lots of downstream impact” (Author interview of Citibank Compliance Executive, 28 August 2015). International banks typically subject customers and businesses in listed countries to more scrutiny, requiring additional identifying documents, delaying transactions, and in some cases, refusing to do business altogether. An official from one of the largest banks in Thailand reported that when the FATF included Thailand on the non-complier list, his bank found that it became considerably more difficult to do business abroad. It took more time to establish business relationships because banks overseas would ask more questions and inquire into the Thai bank’s anti-money laundering practices (Author interview, 9 March 2017).

The most direct negative effect of the FATF list is through transnational correspondent banking relationships. Correspondent banking relationships are bank-to-bank networks that allow financial institutions in other countries to provide services on behalf of other banks. Every country connected through the international financial system relies on correspondent banking to do business across borders, but recent surveys of banks worldwide have found correspondent banking relationships are declining. Erbenova et al. (2016) and Bank for International Settlements (2016). A 2015 World Bank survey found that half of banking authorities, and more than 75 percent of large international banks, reported a decline in correspondent banking relationships between 2010 and 2014. Recent work suggests that banks often withdraw from correspondent relationships due to concerns about the risk of money laundering or terrorist financing (Durner and Shetret, 2015; Erbenova et al., 2016).

The banking sector has an unparalleled ability to sound the alarm about the harmful repercussions of FATF listing. At the start of the FATF non-complier list, many banking officials were already attuned to the possibility of market enforcement due to consequences of

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3Common services include wire transfers, business transactions, and accepting deposits.
the FATF’s previous listing process. \footnote{This process is discussed in greater detail in Chapter 3.} When the FATF started its Non-Cooperative Countries and Territories (NCCT) initiative in 2000, banks around the world restricted business with NCCT countries. Banking officials – regardless of whether their countries were part of the NCCT process – are likely to be aware of how FATF listing might affect their institutions. The leaders of major banks may even remember instructing their offices to avoid transactions with NCCT countries. In the years following 2010, banking officials also became reacquainted with such consequences, either because they reallocated resources away from listed countries or because they themselves were on the receiving end of market enforcement. For all these reasons, the banking community can convincingly articulate the potential costs of the non-complier list.

Politicians often do not understand the potential costs of listing. Political leaders typically have less familiarity with the FATF and its mission since its technocratic meetings are attended by bureaucrats, not politicians. \footnote{This statement is based on the author’s participant-observation at the two FATF-style regional bodies: the Asia-Pacific Group and MONEYVAL.} High-level leaders may engage with the organization during the mutual evaluation process, but are likely to be focused on specific outcomes, not the broader organizational context or related developments in other countries. As a result, political leaders may be unfamiliar with the potential consequences of listing prior to ending up on the list. \footnote{The one exception to this trend seems to be in the Caribbean, where many small countries were listed as part of the NCCT process in 2000 and 2001. Because of the NCCT initiative’s strong effect on the region, news stories suggest political leaders in this region were much more attuned to the possible negative impact of listing. For example, in his statement on Trinidad and Tobago removal from the non-complier list, the Prime Minister explicitly referenced the “devastating economic and reputational consequences” for Bahamas, the Cayman Islands, Saint Kitts and Nevis, and Saint Vincent and the Grenadines, tied to appearing on the FATF’s NCCT list in 2000 (Bissessar, 2012).}

Qualitative evidence suggests domestic banking communities and banking associations alert governments and the public to the consequences of listing through public statements, press releases, and testimonials. Such efforts often highlight widespread financial repercussions for both individuals and companies in listed countries. A year after the FATF listed
Bosnia in 2015, for example, Bosnia’s Bank Association reported that banks in Bosnia had seen their accounts blocked or closed by foreign counterparts, and warned that the list “put in jeopardy the operation of banks and clients, regardless of whether they are firms or individuals” (Sito-Sucic 2016). In Panama, the Executive Vice President of the Banking Association highlighted how the list caused serious problems for banks and commercial customers and morally damaged the reputation of Panama’s banking sector (Castillo 2016).

In some countries, banking associations have also been politically active, lobbying government officials directly to push for improved compliance with FATF standards. In the Philippines, a country that has twice been listed by the FATF and as of June 2017, faces the possibility of a third listing, the Bankers’ Association of the Philippines (BAP) is a long-time advocate for meeting FATF standards. The BAP’s efforts date back to the country’s first anti-money laundering bill, adopted in 2001. Brillo (2010) recounts how the BAP lobbied and attempted to influence lawmakers by arguing that “the banking system would face not only an increase in transaction costs but serious reputational risk, if the law was not passed” (117). Today, sixteen years later, the BAP continues to push the government to comply with FATF standards, as evidenced by its recent testimony in support of legislation to amend the Anti-Money Laundering Act of 2001 so that it covers casinos and the gaming industry (Press and Public Affairs Bureau 2017).

In Guyana, the banking sector has also advocated consistently for improving compliance with FATF standards. Prior to FATF listing, the Guyanese government and the opposition spent more than two years negotiating new anti-money laundering and combating terrorist financing legislation without reaching any agreement. During this period, the local banking community warned repeatedly about the consequences of listing. In January 2014, after the Caribbean Financial Action Task Force issued a public warning to Guyana, the Bankers

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8Guyana is a South American country with a resource-driven economy where citizen income is supplemented significantly by remittances sent from abroad. Its primary risk of money laundering comes from its geography – much of its unpopulated land borders Venezuela, Brazil, and Suriname, making it an ideal transit route for drug traffickers and smugglers (CFATF 2011).
Association of Guyana met with the President to report problems with transferring money and continuing correspondent banking relationships with other foreign jurisdictions. \textit{Local bankers association lament CFATF blacklisting} \citeyear{2014}. Weeks before the FATF listed Guyana in October 2014, the Caribbean Association of Banks urged the Guyanese government to pass necessary legislation, issuing a statement that highlighted the benefits of such action for the country and the region\textsuperscript{9}. The government and the opposition, however, failed to find common ground, due to the opposition’s attempts to tie other legislative priorities to the anti-money laundering bill.\textsuperscript{10} The FATF listed Guyana in late October 2014. When Guyana finally passed legislation the following year, major parts of the Guyana banking community had already begun to abide by the amended requirements; nonetheless, the banking community was hopeful that the government’s action would lead to an improvement in the international business environment. \textit{GBTI CEO ‘relieved’ AML Bill passed – says banks’ guidelines were drawn from amended act} \citeyear{2015}.

6.1.2 Central Bank Advocacy

Due to concerns about market enforcement from foreign investors, central banks also play an important role in pushing governments to change their policies to comply with FATF standards. To understand why central banks care about the non-complier list, it is helpful to consider the market for sovereign debt. Many governments finance their budgets by issuing sovereign debt, sometimes in the form of bonds that are denominated in a foreign currency in order to attract foreign investors. Although both governments and central banks can issue sovereign debt, central banks have a particular interest in how sovereign bonds perform because the central bank is responsible for monitoring the country’s money suppl-

\textsuperscript{9}“Guyana’s expediency in passing the AML/CFT Bill will not only benefit its own economy and growth but strengthen our regional financial network and its reputation worldwide” \citeyear{Freedom FM 2014}.

\textsuperscript{10}For more information on why Guyana failed to pass legislation in advance of listing, see \url{https://www.cfatf-gafic.org/index.php/member-countries/d-m/guyana/101-why-has-guyana-failed-to-pass-an-anti-money-laundering-bill}.  

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ply. For this reason, a central bank has strong incentives to cultivate a positive reputation internationally by implementing domestic policies that follow best practices and make the country competitive with other countries.

Central banks are likely to be particularly concerned about reputational concerns when debt is purchased by foreign investors – a trend increasingly common in recent years. In 2010, emerging market governments sold 1.3 trillion dollars of debt on the international market. Five years later, the number had nearly doubled to 2.2 trillion (IMF and World Bank 2016). Foreign investors are buying much of this debt. One IMF study indicates that between 2010 and 2012, foreign investors spent close to half a trillion dollars purchasing debt from emerging economies between 2010 and 2012 (Arslanalp and Tsuda, 2014).

As chapter 4 explains in greater detail, when investors purchase sovereign debt from foreign countries, they are interested in two kinds of risk: ‘economic risk,’ which is a government’s ability to repay, and ‘political risk,’ which is a government’s willingness to repay. Economic risk is typically tied to factors like a government’s current level of debt, exports, economic growth, and exchange rate stability, while political risk may be linked to government stability, internal or external conflict, and bureaucratic quality. Investors rely on a variety of informational sources to understand and assess such risks. Credit rating agencies like Moody’s and Standard & Poor’s evaluate a government’s creditworthiness, issuing final ratings based in part on intangible factors like a government’s “propensity for ‘orthodox’

11Sovereign debt helps a country develop a credit market and provides collateral for secure financial transactions; the yield on sovereign debt also serves as a baseline for pricing other debt instruments in the same market (Vajs, 2014).

12While individual investors or rating agencies may consider slightly different factors in evaluating political and economic risk, certain government characteristics are likely to be common across actors. In this dissertation, I use the Political Risk Group’s methodology as a benchmark, because the Group provides quantitative risk assessments of countries to numerous investors, private equity firms, and multilateral institutions. The Political Risk Group assesses ‘political risk’ by evaluating government stability, socioeconomic conditions, investment profile, internal/external conflict, corruption, religious and/or ethnic tensions, military and/or law and order concerns, democratic accountability, and bureaucratic quality. PRS assesses ‘financial risk,’ which it defines as a government’s ability to finance its official, commercial, and trade debt obligations, by considering the foreign debt-to-gdp ratio, foreign service debt-to-exports ratio, current account-to-exports ratio, net international liquidity (months of import cover), and exchange rate stability.
vs. ‘heterodox’ policy responses when under acute debt-service pressure’ (Bhatia, 2002: 27). Investors also seek out additional, more up-to-date information if they want to trade bonds in secondary markets, since credit rating agencies are typically slow to change country ratings.

The FATF non-complier list is a natural input into an international investor’s decision-making process because it signals information about both economic and political risk. From an economic standpoint, listed countries suffer clear financial penalties due to market enforcement from banks, with implications for trade and exchange rate stability. When banks close correspondent bank accounts with listed countries or restrict foreign transactions, it becomes more costly for listed countries to trade internationally. The majority of cross-border capital flows are conducted in US dollars or Euros; when financial institutions close correspondent bank accounts, they often cut off access to these key currencies, which are essential for international trading relationships. For this reason, in regions like the Caribbean, where trade is between 70 and 130 percent of gross domestic product (GDP) for most countries, governments have been extremely concerned about the impact of the FATF list on de-risking and macroeconomic performance.

The FATF non-complier list also provides information about political risk, i.e. a government’s willingness to repay its debt obligations. The FATF is one of the few multilateral institutions that set global standards for the financial industry. When the FATF puts a country on the non-complier list, this action signals that the government is lagging behind in financial regulation and failing to implement best practices. This signal is particularly strong in the case of the FATF non-complier list because countries are given ample time to improve compliance in order to avoid listing. At a minimum, FATF global network countries

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13 After a government issues a bond, investors can trade it in the secondary “over-the-counter” market, which .

14 Indeed, Standard & Poor’s specifically clarifies that it “assumes no obligation to update the Content (of a rating) following publication in any form or format” (Standard & Poor’s, 2014: 17).

15 For a detailed discussion of how de-risking has affected macroeconomic sectors in the Caribbean, see Williams (2016).
have two years between the revision of FATF standards and ending up on the non-complier list, and most countries have substantially more time. Given the possibility of significant economic consequences from listing, if a government fails to avoid the non-complier list, this lack of action signals a lack of capacity or political will.

Because international investors integrate the non-complier list into resource allocation decisions, central banks have become allies for the FATF and work to improve their country’s compliance with financial integrity standards. Central banks, particularly in emerging markets, monitor their own progress and relative performance on these issues through comparative indices, such as the Basel Anti-Money Laundering Index (Author interview with Project Manager Basel AML Index, 17 February 2016). In some countries, the central bank has gone beyond domestic regulation to ensure its financial institutions meet FATF standards, regardless of whether such measures are enforceable (Author interview with Executive Director of FSRB, 30 June 2016). The central bank’s role in pushing for policy change may also increase over time, as bank governors become more aware of the significance of the FATF list. When the FATF listed Thailand in 2010, the parliament and the Bank of Thailand initially did not realize the significance of the FATF or the listing process. Once Thai banks began reporting slowed transactions and halted business relationships, however, the government and central bank changed their approach. Thailand was removed from the list in 2013, and since that time, the Bank of Thailand has become considerably more focused on financial regulation and FATF compliance (Author interview with Thai bank executive, 9 March 2017).

In other listed countries, the central bank was a strong advocate for policy change as soon as listing occurred. In Ethiopia, the central bank had worked very hard in the years prior to listing to follow best practices and become a destination for foreign investors. When the FATF listed the country in 2010, the bank was preparing to issue its first-ever Euro bond,

\[15\] The FATF evaluation cycle is ten years. Some countries are evaluated soon after the FATF revises its standards, while others are evaluated much later in the cycle.

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and was concerned about issuing the bond while being on a “blacklist.” According to an official from a private bank in Ethiopia, the central bank was the “real impetus” for policy change because bank officials were concerned about foreign investment and reputational effects (Author interview, 11 February 2016). The FATF removed Ethiopia from its list in 2014.

### 6.2 Measuring Market Integration

Because the FATF non-complier list leads to market enforcement, countries with high levels of market integration are most likely to change their policies in response to listing. The concept of “market integration” is intended to capture the degree to which a country’s government and economy is integrated into and dependent on international financial markets. Due to the complex nature of the global economy, there are many potential pathways for a country to be connected to other countries through financial flows. A country where trade makes up a significant portion of GDP is highly integrated, as is a country where trade is low but GDP depends significantly on remittances from abroad. High market-integration countries might also be those with high levels of foreign direct investment (FDI), or those that sell bonds to international investors.

In this project, I proxy market integration using data on cross-border bank flows. Bank-to-bank financial transactions are a key part of the global economy. Banks establish correspondent banking relationships with banks in other jurisdictions so that a bank in one country can provide a deposit or liability account and related services to a bank in another country. As discussed earlier, correspondent banking is essential for many types of global transactions, including the execution of third-party payments, trade finance, short-term borrowing, and foreign investment.\(^\text{17}\)

\[^{17}\text{For more on correspondent banking relationships, please see IMF (2017).}\]
I operationalize a country’s level of market integration as its aggregate cross-border liabilities in 2008, one year prior to the FATF’s new non-complier list procedures.\footnote{I use this early time period to indicate market integration prior to the creation of the non-complier list. Once the FATF created its non-complier list procedures, cross-border liabilities may have already begun to decrease in anticipation of possible listing.}

Chapter 4 explains why international banks have both regulatory and reputational incentives to slow or halt transactions with banks and individuals in high-risk countries. Building on this analysis, I assume that countries where banks have significant cross-border liabilities are more likely to change their policies in response to market enforcement.

- **Market Integration Hypothesis**: Listed countries with higher levels of market integration should adopt FATF-compliant laws on terrorist financing more quickly than listed countries with lower levels of market integration.

As a measure of market integration, cross-border liabilities (bank-to-bank borrowing) has several strengths. First, cross-border flows enable many types of global market activity, and as a result, the measure correlates with many other possible measures of market integration. Figure 6.1 illustrates how cross-border liabilities in 2015 correlate with GDP, exports, FDI, and remittance flows. In general, cross-border liabilities appear to track closely with other types of market integration, although the relationship is less robust for remittances. Cross-border liabilities may also reflect sovereign risk; if investors view listed countries as riskier investment prospects, banks in listed countries may find it more costly and difficult to obtain funding.\footnote{For a discussion of the relationship between sovereign credit risk and bank funding conditions, see Committee on the Global Financial System (2011).}
Figure 6.1: *Cross-Border Liabilities as Proxy for Market Integration* - The plots above show how domestic bank borrowing from international banks (cross-border liabilities) correlates with other possible measures of market integration as of 2015. Data is for all 141 countries included in the analysis.
6.3 Analyzing Markets as Moderators for Policy Change

My analysis examines how the FATF non-complier list and a country’s level of market integration affect the length of time that it takes for the government to adopt an FATF-compliant law on terrorist financing. I start my analysis in February 2010, when the FATF issues its first new non-complier list, and my data runs through December 2015. The unit of observation is the country-month.

I test my theory using a Cox Proportional Hazards model, which analyzes how variables affect the length of time (in months) that it takes for a country to criminalize terrorist financing in line with FATF standards. This model assumes that the data is unidirectional – once a country has fully criminalized terrorist financing, the country drops out of the analysis under the assumption that the government is unlikely to repeal its law. Due to this approach, countries that criminalized terrorist financing in line with FATF guidelines prior to February 2010 are excluded from the analysis.

My simplest model includes data for 141 countries, including 45 of the 57 countries listed as part of the non-complier list between 2010 and 2015. As I add covariates, the sample drops to 123 (40 listed countries) and then to 87 (31 listed countries). In the baseline model, this equates to 7,019 observations and 72 events (instances where a country criminalizes terrorist financing in line with FATF guidelines and is removed from the sample). The most comprehensive model includes 4,563 observations and 50 events. The results are robust to running all models on the smallest sample. All variables in the models are centered around zero.

\[ \text{The results are robust to running all models on the smallest sample.} \]
6.3.1 Dependent Variable: Policy Change on Terrorist Financing

My dependent variable is a dichotomous indicator of whether a country has adopted a comprehensive law on terrorist financing that meets FATF standards. As discussed in Chapter 5, the adoption of an FATF-compliant law on terrorist financing is a clear indication of policy change because all of the countries included in the analysis had not adopted compliant laws as of February 2010. To create this variable, I reviewed FATF mutual evaluation reports and follow-up reports, the FATF’s Terrorist Financing Fact-Finding Initiative, news reporting, and country laws pertaining to terrorism. I code countries as compliant when they adopt a law that extends to any person who willfully provides or collects funds with the intention or knowledge that they are to be used to carry out a terrorist attack, by a terrorist organization, or by an individual terrorist.\footnote{This language is in line with section 2 of the FATF Interpretive Note to Recommendation 5 (Terrorist Financing Offence) \cite{FATF-GAFI:2012}.} Additional details on this variable are provided in Chapter 5.

6.3.2 Explanatory Variables

If the reputational effects of listing are intensified by markets, then listed countries with high market integration should be quicker to change their policies in response to listing. As such, the independent variable of interest is the interaction between a country’s listing status and its level of market integration. I create a dichotomous variable \textit{Listing}, which indicates whether a country is on the FATF non-complier list in a given month.\footnote{Although the FATF non-complier list actually consists of four levels of listing, in this analysis I collapse all four levels into one measure. For an alternative operationalization that more closely accounts for listing levels, please see Chapter 5.} In the largest version of the data, approximately 18 percent of observations are coded as 1’s. I also create the continuous variable \textit{Market Integration}, which reflects a country’s aggregate cross-border liabilities in 2008, a year prior to the FATF’s new listing procedures. Market integration
ranges from 28 million to 6.9 trillion. Because the data is highly skewed, I transform the variable by taking the log.

A country’s direct ties to the FATF may also affect how quickly it meets FATF standards on the criminalization of terrorist financing. I include the variable \textit{FATF Member} to account for whether a country is a member of the FATF in a given year\textsuperscript{23} Countries may also be influenced by the policies of neighbors or regional partners through processes of policy diffusion (Gleditsch and Ward 2006; Elkins, Guzman and Simmons 2006; Simmons and Elkins 2004). In the context of the FATF, Sharman (2008) argues that diffusion has affected the adoption of anti-money laundering policies throughout the developing world. I account for this possibility with the variable \textit{Diffusion}, which ranges from 0 to 1 and for each country, represents the percentage of member states in the country’s FATF regional affiliate that have adopted FATF-compliant laws on terrorist financing\textsuperscript{24}

There are several additional reasons for why countries might adopt FATF-compliant laws on terrorist financing. A government’s capacity to pass new legislation and meet international standards is likely to affect the time to policy change. Following previous studies (Horn, Mavroidis and Nordström 1999; Guzman and Simmons 2005), I control for \textit{Capacity} using GDP per capita, which proxies for human capital\textsuperscript{25} Countries that face a higher threat of terrorism might also be faster to comply with FATF recommendations on terrorist financing. I include the variable \textit{Terrorism Risk}, which ranges from 0 (lowest risk) to 3 (highest risk)\textsuperscript{26}

\textsuperscript{23}Because almost all of the countries in the sample are members of FATF-style regional bodies, I do not include regional membership as a control.

\textsuperscript{24}For comparability across institutions, the variable is scaled by rounding to nearest 0.1 value in the regression.

\textsuperscript{25}This variable is drawn from the World Bank World Development Indicators, and is standardized in 2010 US dollars. Due to the skewed distribution and for ease of interpretability, I transform the variable by adding 1 and taking the log.

\textsuperscript{26}This variable is drawn from the International Country Risk Guide, which compiles monthly data on political risk in 150 countries. The original variable scales from 1 (highest risk) to 4 (lowest risk). For ease of interpretability, I have inverted the variable and set the minimum value at 0.
its ability or willingness to fulfill international commitments.\(^27\) To account for the possibility that democratic institutions may affect how quickly a country criminalizes terrorist financing in line with FATF standards, I include Democracy, which is drawn from the Center for Systemic Peace.\(^28\) I supplement this data with information drawn from Gleditsch (2013). Because Polity data are not available for 2014 or 2015, I extend the values for 2013 to 2014 and 2015.

Ties to the United States may also impact a country’s willingness or ability to criminalize terrorist financing in line with FATF recommendations. The FATF’s regulatory agenda aligns closely with US foreign policy objectives (Jakobi, 2013), and the US government views international cooperation on combating terrorist financing as integral to forestalling terrorist attacks.\(^29\) To account for the possibility that the United States may independently pressure its allies to comply with FATF guidelines, I include the variable US Ally, which is drawn from the Correlates of War project and indicates whether a country has a defense pact, entente, or neutrality agreement with the United States in a given year (Gibler, 2009). Because the United States may directly pressure allies to adopt comprehensive laws, regardless of FATF listing status, the underlying baseline rate of adoption for US allies is likely to be different from the baseline rate of adoption for non-allies. For this reason, I model US Ally as a distinct stratum rather than a control variable.\(^30\)

### 6.3.3 Confounders

Selection into the FATF non-complier list is not randomly assigned. If the FATF’s decision to list a state is positively correlated with its probability of adopting an FATF-compliant

\(^{27}\) See, for example, Helfer and Slaughter (1997), Raustiala and Victor (1998), Martin (2000), or Mansfield, Milner and Rosendorff (2002), among others.

\(^{28}\) Available at: [http://www.systemicpeace.org/inscrdata.html](http://www.systemicpeace.org/inscrdata.html)

\(^{29}\) See, for example, the staff report of the 9/11 Commission (Roth, Greenburg and Wille, 2004) or the remarks of then Under Secretary for Terrorism and Financing Intelligence David S. Cohen, delivered to the Carnegie Endowment for International Peace (Cohen, 2014).

\(^{30}\) Log-rank tests comparing the time to criminalize terrorist financing for US allies and non-allies confirm that stratification is appropriate.
law on terrorist financing, then this relationship could bias the regression results in favor of the theory. More specifically, if the FATF is more likely to list probable compliers than probable non-compliers, this would bias the results in favor of a finding. I probe the direction of selection effects by examining the pool of countries eligible for listing based on FATF criteria. Within this group, I examine the percentage of listed and non-listed countries that had adopted laws on terrorist financing as of 2009. Comparing these two groups yields similar percentages of likely-to-comply states – 52 percent of eligible, but not listed, countries had some kind of law on terrorist financing as of 2009, whereas 60 percent of listed countries had laws. The difference between these values is not statistically significant (p-value from t-test: 0.44).

To account for the possibility, however, that the FATF may be more likely to list countries that are more likely to comply with FATF standards, I include the variable *Previous Terrorist Financing Law* in my analysis. This variable indicates whether a country had some type of law on terrorist financing as of the end of 2009 (two months before the start of the non-complier list). Since the hazard design requires excluding all countries that had FATF-compliant laws on terrorist financing as of February 2010, this variable is coded 1 if a country had taken steps to criminalize terrorist financing but the existing legal framework was insufficient. Of the 141 countries included in the analysis, 96 (68 percent) had adopted some type of non-FATF compliant law on terrorist financing by the end of 2009.

I also control for the FATF’s stated selection criteria. The FATF builds a pool of eligible countries based on the results of mutual evaluation reports. In the third round of evaluations, all countries that received failing scores on 10 or more of the 16 most important recommendations were eligible for listing. In general, the FATF and its regional bodies only evaluate a country once per cycle, so for most countries, the number of failing recommendations does

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31 As discussed in previous chapters, many countries had passed weak, non-compliant laws on terrorist financing before the non-complier list. If we assume that previous legislation is a good signal of future intent, then the percentage of listed and non-listed countries with non-compliant laws as of 2009 provides some insight into selection.
not change across the data set. Because even the possibility of being included on the non-complier list is likely to drive policy change, the underlying baseline rate of adoption for countries with 10 or more failing recommendations is likely to be different from the baseline rate of adoption for countries with less than 10 failing recommendations (which do not face the threat of listing). For this reason, I include \textit{10+ Failing Recs} but model this variable as a distinct stratum rather than a control variable.\footnote{Log-rank tests comparing the time to criminalize terrorist financing for countries with 10 or more failing recommendations and countries with 9 or fewer failing recommendations confirm that stratification is appropriate.}

The FATF decides whether or not to list countries that are above the 10-failing-recommendation threshold on the basis of several factors. The most important determinant is the size of a country’s financial sector – in particular, the percentage and total assets held in non-resident accounts (\textit{FATF-GAFI} 2009\textsuperscript{b}). As a proxy for this factor, I include \textit{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 investment, other investment, and reserve assets.\footnote{For more on this measure, please see \\texttt{https://www.imf.org/external/np/sta/bop/BOPman.pdf}.} In 2015, Germany had the largest positive net financial account of any country in the data set (324 billion US dollars) and Brazil had the largest negative value (-100 billion US dollars). Because large positive or negative values equate to larger financial sectors, I take the absolute value of this variable, and then log it to account for the highly skewed distribution.

6.4 Findings: Markets as Moderators for Policy Change

The results provide strong support for the hypothesis: market integration intensifies the effect of listing. Listed countries with high levels of market integration (proxied by 2008
cross-border bank liabilities) adopt comprehensive laws on terrorist financing more quickly than listed countries with low levels of market integration.

Table 6.1 shows the effect of listing and market integration on the time that it takes for a country to criminalize terrorist financing in line with FATF standards. Model 1 shows the effect of listing and market integration on criminalization, including only those controls most likely to affect whether a country ends up on the non-complier list. Model 2 adds controls for diffusion, financial account, and capacity. Model 3 extends the analysis to account for possible alternative explanations, such as terrorism risk, level of democracy, and whether a country is a US ally. All three models are stratified by whether a country is at risk of being listed, i.e. the country has 10 or more failing recommendations on its FATF evaluation.

Across all models, the interaction of listing and market integration has a positive and statistically significant effect on the probability that a state criminalizes terrorist financing. In the full model, doubling a country’s cross-border liabilities makes it 1.4 times more likely to criminalize terrorist financing in a given period. While a 100 percent increase in a country’s cross-border possibilities may seem like a large change, consider that between 2002 and 2009, at least five countries in Europe had cross-border liabilities that increased by more than this amount.

Figure 6.2 shows how market integration affects the cumulative probability that a state criminalizes terrorist financing over time. The figure shows the change in cumulative probability and 90 percent confidence intervals for moving from one standard deviation below the mean value of cross-border liabilities to one standard deviation above the mean. After two years on the non-complier list, high market integration countries are 50 percent more likely to criminalize terrorist financing in a given period than low market integration countries.

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34 Under the assumption that US allies may have different baseline probabilities of adopting FATF-compliant laws, I model the variable USally as a distinct strata.
35 These countries are Denmark, Norway, Sweden, Finland, and Ireland. Data based on Table 1.1 in Allen et al. (2011).
36 This difference is approximately equivalent to the difference between 152 million and 7.8 billion, or the difference between market integration in a country like Senegal and a country like the Philippines.
Figure 6.2: The figure shows the change in cumulative probability of adopting an FATF-compliant law on terrorist financing when market integration increases from one standard deviation below the mean to one standard deviation above the mean. First difference calculations estimated using the results of Model 3 in Table 6.1. Dotted lines show the 90 percent confidence interval, calculated using a Monte Carlo simulation sampling over 500 iterations.

Listing also has a positive and statistically significant effect on policy change across all three models in Table 6.1. This result suggests that the reputational effects of listing go beyond changes in bank-to-bank financial flows, and may include other types of market enforcement that correlate less closely with cross-border liabilities. For example, the FATF non-complier list reportedly has impacted remittance flows, yet such flows might not be captured with cross-border banking data since many individuals send remittances through money transfer firms. Similarly, the impact of the non-complier list on investors purchasing sovereign debt may not be fully captured by this measure of market integration.

In some cases, the FATF non-complier list may drive policy change because governments anticipate the possibility of future market enforcement. Policymakers in listed countries often

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37 For more on how global anti-money laundering and combating terrorist financing policy has affected the remittance market, see Finance and Markets Global Practice (2015).
justify new legislation by citing concerns about future financial penalties. When Trinidad and Tobago was removed from the FATF list in 2012, the country’s prime minister suggested that he was motivated to improve compliance due to the “devastating economic and reputational consequences” experienced by several other Caribbean states during the previous FATF listing process. He noted that his government did not highlight the potentially damaging effects of the FATF non-complier list for fear of undermining investor confidence, but instead, chose to take immediate steps to remedy the country’s deficiencies. Such statements suggest that the FATF non-complier list’s negative effect on reputation is often still linked to market enforcement, even if such processes may be difficult to observe.

6.5 Thailand: Financial Reputation Driving Policy Prioritization

Thailand’s experience with the non-complier list shows how the reputational consequences of listing combine with market enforcement to generate policy change. When the FATF listed Thailand in February 2010, the country was in compliance with very few FATF recommendations. The Thai government viewed anti-money laundering and combating terrorist financing as a low priority. The FATF non-complier list’s impact on markets, however, shifted priorities, as the banking community and private sector actors began to advocate for compliance. Over the course of a few years, Thailand significantly improved its policies and was subsequently removed from the list.

6.5.1 Background

Although Thailand seems like a country that would be highly motivated to meet FATF standards, its compliance record prior to the non-complier list was fairly poor. Thailand is highly

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38 The Prime Minister was referring to the FATF’s Non-Cooperative Countries and Territories process (2000 - 2006), which is discussed in more detail in Chapter 3.
integrated into the global economy, and is also susceptible to money laundering and terrorist financing.\[^{39}\] Despite these factors, the Thai government did not prioritize compliance with the FATF recommendations in the early 2000s. When FATF-affiliate the Asia/Pacific Group on Money Laundering (APG) evaluated Thailand in 2007, its monitoring report rated Thailand as fully compliant with only 2 of the FATF’s 49 recommendations. Thailand received non-compliant or partially compliant ratings on more than half of the recommendations, including all nine of the recommendations on combating terrorist financing.

### 6.5.2 Thailand and the Non-Complier List

When the APG published Thailand’s evaluation in 2007, the FATF had very few tools in place to deal with non-compliant jurisdictions. The repercussions of non-compliance were minimal – Thailand had to submit follow-up reports to the APG. In 2009, however, the FATF revitalized its process for dealing with non-compliant jurisdictions. When the FATF issued its first non-complier list in February 2010, Thailand was one of 20 countries listed at the lowest level. In its first statement, the FATF called on Thailand to criminalize terrorist financing, establish and implement procedures to freeze terrorist assets, and strengthen its supervision of relevant laws.

Thailand’s Anti-Money Laundering Office (AMLO) responded immediately to listing, launching a big public information campaign to try and convince the government to change its policies (Author interview with Thai government official, 14 February 2016). Yet the government response was sluggish. According to a senior Thai banking official, while the AMLO recognized the significance of listing and the possible financial repercussions, the government was slow to understand the possible consequences (Author interview, 9 March 2017). As a

\[^{39}\]Thailand’s problems with money laundering reflect the frequency of cash transactions, the country’s large informal sector (including an illegal economy that is estimated to be up to 13 percent of GDP), and a history of corruption (IMF [2007] 24). Thailand’s risk of terrorist financing is linked in part to Thailand’s problems with domestic terrorism. Thai authorities estimated that there were 873 terrorist incidents in the southern provinces in 2004, and that annually, terrorists in the south receive 5-10 million baht (132,000 - 264,000 US dollars) for carrying out terrorist attacks (IMF [2007] 20).
result, by the end of 2010, Thailand had approved a national anti-money laundering and combating the financing of terrorism strategy and drafted a proposed law to criminalize terrorist financing (US Department of State, 2011), but made no other improvements.

In this first year, the market response was negligible. Since the list was so new, it received very little media attention; indeed, The Wall Street Journal did not publish a single article about the FATF list in the six months following its creation. Additionally, because the non-complier list included several different lists, it was difficult for outside observers like banks, investors, or even other countries to know how to interpret the meaning of a country’s inclusion on one of the lists. For this reason, market actors were slow to integrate the list into decision-making practices.

By February 2011, however, the FATF had issued three listing announcements, each of which described ongoing compliance problems in listed countries. As such, third-party observers like banks and investors began to realize that many countries would require significant legal change before the FATF would remove them from the list. Market actors began to adjust risk appraisals accordingly. For Thailand, a country with an economy heavily dependent on trade and investment, the response from markets was crucial for driving policy change. It became more difficult for Thai banks to do business abroad, as foreign banks began to ask more questions about anti-money laundering rules and regulations (Author interview with Thai banking official, 9 March 2017). The Thai business community became particularly concerned about the list, as foreign transactions took longer and were more costly than before (Author interview with Thai government official, 14 February 2016). Despite these costs, Thailand failed to make significant changes to its legal framework in 2011, due partly to domestic political unrest.

In October 2011 the FATF placed Thailand on a list of

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40 This lack of media attention is notable compared to 2014 and 2015, when The Wall Street Journal published approximately 5-6 articles per year mentioning the FATF non-complier list.

41 According to a State Department assessment “Political and civil unrest in Thailand in mid-2010, followed by catastrophic flooding, the dissolution of Parliament and subsequent general election in July 2011, have impeded Thailand’s implementation of its AML/CFT action plan” (US Department of State, 2012, 171).
countries not making enough progress. In February 2012, Thailand was bumped up to the so-called “blacklist.”

The higher listing level intensified the costs to Thailand’s financial sector and increased pressure on the government to change its laws. Thai banks reported difficulties obtaining permits to open branches in EU countries, and a bank in the EU even contemplated scrapping a deal to lend money to Thai banks (Author interview with Thai government official, 14 February 2016). The AMLO suddenly had new allies, as the Board of Trade, the Federation of Thai Industries, the Thai Bankers Association, and the Federation of Capital Markets Association began joint action with the AMLO and the Attorney General’s office to push for new laws on money laundering and terrorist financing (Private sector pressures for solution on FATF blacklist - The Nation 2012). Less than a month later, in May 2012, Deputy Prime Minister Kittiratt Na-Ranong promised Thailand would amend its Anti-Money Laundering Act by the end of the year. In a public statement, Na-Ranong linked anticipated policy change directly to the FATF list (Fernquest 2012). The Thai government followed through on its promises, passing new laws on money laundering and terrorist financing weeks before the February 2013 FATF plenary. Following an on-site visit to confirm progress, the FATF removed Thailand from the non-complier list in June 2013.

6.5.3 Financial Costs of Listing

Quantifying the full impact of the non-complier list on Thailand’s economy is difficult due to the diverse ways in which the list affected financial flows. There is, however, at least correlational evidence that the non-complier list affected cross-border liabilities. Figure 6.3 shows cross-border liabilities (money that Thai banks owe to international banks) between 2009 and 2015. When the FATF listed Thailand in February 2010, cross-border liabilities stayed relatively stable; however, after the FATF bumped Thailand up to a higher listing level in February 2012, cross-border liabilities declined significantly. As Thailand started to
Figure 6.3: The figure shows cross-border liabilities (billions of US dollars) from 2009 to 2015. The FATF listed Thailand in February 2010 and in February 2012, placed Thailand on its “black” list for failing to improve its laws in a timely fashion. Following significant legal changes, the FATF removed Thailand from its monitoring process in June 2013.

modify its policies, cross-border flows began to increase again, and this trend continued for a year after Thailand’s removal from the list.

There is also correlational evidence that the non-complier list affected the risk premium for long-term debt. Figure 6.4 shows the yield spread for 10-year bonds sold by the Thai government between 2009 and 2015. In the two years following Thailand’s listing, the spread rose from 1.1 to 2.2, as investors viewed Thailand as an increasingly risky investment prospect. While it is true that Thailand experienced a number of challenges during this time, such as massive floods and political unrest, these events do not appear to correlate with bond spreads. For example, in the latter part of 2011, Thailand had major flooding, leading to billions of dollars in economic damages (Quadir 2012), yet the yield spread was already increasing prior to flooding and increased more after the floods ended. During the period of
Figure 6.4: The figure shows the yield spread for long-term debt (10-year bond) sold by government of Thailand between 2009 and 2014. The FATF listed Thailand in February 2010. In February 2012, the FATF placed Thailand on the “black” list for failing to improve its laws in a timely fashion. Following significant legal changes, the FATF removed Thailand from its monitoring process in June 2013.

massive political turmoil in late 2013, the yield spread was actually decreasing. While the figure does not provide definitive evidence of a causal link between the non-complier list and bond yields, it suggests that the non-complier list and yield spreads are correlated.

Since Thailand was removed from the FATF list in June 2013, the Thai government has continued to improve its compliance with FATF standards, albeit at a slower pace. The AMLO has taken a much more active role in regulating the banking sector, clarifying bank reporting obligations and promoting information sharing on this issue (Author interview with Thai banking official, 9 March 2017). In 2016, the APG conducted its year-long evaluation of Thailand as part of the FATF’s fourth round of evaluations. The results of this report,
which was adopted in July 2017 but is not yet publicly available, will show to what extent the non-complier list process has generated long-term policy change in Thailand.

6.6 Conclusion: Markets as Drivers for Reputation

Market actors intensify the consequences of reputational damage. The FATF non-complier list surely imposes normative and elite-level costs; however, the reputational mechanism that drives policy change is market enforcement. International banks and investors have clear, profit-based incentives to integrate information from the non-complier list into their decision-making processes, and to reallocate resources accordingly. Because these processes of market enforcement directly hurt domestic banks in listed countries, banking associations advocate for policy change. Central banks in listed countries have also played a role in pushing governments to increase compliance with FATF standards. For commercial banks and central banks, the goal is simple: to improve their countries’ reputations among international financial actors.

This chapter provides strong evidence for the link between reputation and market enforcement. If reputational damage matters most because of market punishment, then countries that are highly integrated into the global economy should be most sensitive to reputational consequences of listing. I provide quantitative evidence supporting this observable implication, showing that listing has the strongest effect on countries that are highly integrated in global markets. My case study of Thailand sheds additional light on this process, highlighting how different types of market enforcement promote increased compliance with FATF standards. Overall, the evidence suggests that market actors are powerful moderators for reputational costs.
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<td>1.356**</td>
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<td>(0.151)</td>
<td>(0.197)</td>
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Note: *p<0.1; **p<0.05; ***p<0.01

Table 6.1: Effect of Listing and Market Integration on Criminalization - Hazard ratios for cox proportional hazards models. Values over 1 indicate a positive effect; values below 1 indicate a negative effect. Standard errors are clustered by country and shown in parentheses. All models stratified by 10+ Failing Recommendations; Model 3 also stratified by US Ally.
Chapter 7

When Does Reputation Matter?

How do states acquire reputations? And what types of information cause reputations to shift? Such questions are integral to our understanding of international relations, where for decades, scholars have posited that reputation is a key mechanism for explaining international cooperation (Keohane 1984; Axelrod 1984; Sartori 2005; Tomz 2007; Simmons 2010; Kelley 2017), bargaining (Schelling 1960; Tomz 2007a), and war (Fearon 1995; Dafoe, Renshon and Huth 2014). A state seeking to negotiate a new agreement may find more willing partners if it has a reputation for upholding previous commitments. A state threatening military action may find its adversaries are more ready to concede when it has a reputation for resolve. Such reputational effects may be even more important in the modern era, where new information is constantly available to update and reshape beliefs.

Yet despite these theorized pathways, empirical evidence that illustrates the impact of reputation has been quite mixed. While civil society activists and investors are willing to impose reputational penalties on uncooperative states in certain contexts, state-to-state relationships change much more slowly. Indeed, some agreements are even designed specifically to allow for periodic deviations and rule violations without incurring reputational penalties (Abbott et al. 2000; Rosendorff and Milner 2001). Because state-to-state relations are complex and reflect a variety of considerations, states acquire different reputations across
different issue areas and may be willing to tolerate a fair amount of uncooperative behavior from other countries (Downs and Jones 2002). Within each country, some types of reputations may more responsive to new information than others. All of this suggests that to understand reputation, we must first identify the conditions under which information leads particular actors to update their views of state behavior and how this affects state policy.

In this dissertation, I have analyzed the role of information and reputation in international relations by examining how an international organization’s monitoring and assessment procedures transformed international cooperation on financial integrity. The dissertation opened with a description of this important but understudied policy area. Between 2 and 5 percent of the global gross domestic product – roughly 1 to 2 trillion US dollars – is estimated to be illicit financial flows. Efforts to fight money laundering date back to the 1980s, but since the 9/11 terrorist attacks, global cooperation on financial integrity has increased exponentially. For many years, despite strong institutional rules and widespread political support, legal change on terrorist financing fell far short of international commitments. As of late 2009, less than 10 percent of countries had adopted comprehensive laws criminalizing terrorist financing. Yet between 2010 and 2015, policy change suddenly became widespread, and today, almost every country in the world has laws that meet international standards.

What explains this significant increase in cooperative behavior? The answer, I argue, is that an international organization (IO) manipulated the reputational consequences of non-compliant behavior. This dissertation lays out a theory that suggests an institution’s ability to drive policy change through reputation depends on information that is credible, precise, and relevant to actors’ priorities. When IO monitoring is fulfills these scope conditions and is relevant to market actors, it can lead to a market enforcement process whereby banks and investors reallocate resources away from non-compliant states. I use this market-based

\[1\text{Estimates vary widely on this, but most analyses suggest illicit financial flows account for at least 1 trillion dollars annually. A recent report by Global Financial Integrity estimates more than 1 trillion dollars flowed out of developing countries alone in 2013 (Kar and Spanjers 2015).}\]
theory of reputation and enforcement to explain the significant improvement in international cooperation on combating terrorist financing since 2009. Below, I summarize my theory and findings, and then discuss my theoretical contributions and the implications of my work for public policy. Finally, I conclude by offering several possible extensions for future scholarship.

7.1 A Market-Based Theory of Reputation and Enforcement

Reputation is a conglomeration of observations and beliefs. Faced with incomplete information about a foreign government’s true nature, states and non-state actors form opinions about a government’s type. While existing theories draw attention to a government’s actions and behavior, the theory presented in this dissertation suggests that informational inputs are more complex. To have the strongest effect on a country’s reputation, information must be credible, precise, and relevant to an audience’s priorities. Under such conditions, reputational damage can drive third-party enforcement. When third parties are market actors who reallocate resources away from non-compliant states, this process can become a major driver for policy change and improve cooperative outcomes.

New information is more likely to affect the reputation of a target state when the source of the information is credible and legitimate. Compared to states, IOs may be more credible and legitimate monitors because they are typically less tied to political or strategic calculations. IOs may also have advantages over non-state actors in issue areas where monitoring requires significant access to state policy, since IOs can draw on established relationships with government bureaucracies to extract information. Within the population of international organizations, institutions where monitoring is insulated from interstate politics (perhaps through delegation) will be more credible sources of information than when monitoring is directly controlled by states.
An IO can enhance the reputational consequences of negative information when it sends a clear and precise signal about non-compliant behavior. IO monitoring affects a state’s reputation by reducing uncertainty about the state’s behavior and also about how other observers are likely to view the state. While some types of actions in international politics leave no room for ambiguity, most state behavior is fairly opaque. When a detailed monitoring report describes how a government is stifling human rights or engaging in corruption, states and non-state actors interpret information independently and formulate their own conclusions. In contrast, when the monitor releases its findings through a rating, ranking, or blacklist, the precision of the information sends a clear signal about non-compliance and intensifies reputational effects.

Information is most likely to impact a country’s reputation when monitoring is relevant to the priorities of a resource-rich audience. The logic for this is straightforward – information revealing a particular type of uncooperative behavior will matter most if there are actors making decisions primarily based on that type of behavior – but it has important observable implications. First, states are less likely than non-state actors to impose reputational costs on non-compliant states. While bilateral relations are typically multifaceted and nuanced, non-state actors often have more narrowly focused interests. As a result, new information about state behavior is more likely to drive non-state actors to shift their behavior toward uncooperative states.

Second, reputational effects are likely to vary across issue areas and across time, depending on the availability of an audience with unidimensional or narrow preferences. External conditions like regulation, donor priorities, or consumer preferences can shift the incentives of audiences to act as potential enforcers. A human rights organization, for example, may be more responsive to information about a government’s poor treatment of refugees if a large donor or foundation suddenly decides that refugees is a priority issue. Perhaps the best

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2 Examples include testing a nuclear weapon or defaulting on debt.
opportunity, however, for information to affect reputation is in the financial realm, where market actors have one key objective: to maximize profit. Information that signals a foreign country is a riskier investment prospect is likely to damage a country’s reputation with markets.

Reputational damage is a particularly powerful driver of widespread policy change when actors reallocate resources in response to information. Among the many types of non-state actors, markets actors like banks and investors are most likely to reallocate resources in response to new information because uncertainty is high and decision-making is interdependent. Market actors make decisions based on their beliefs about a foreign government’s past and future behavior. Market decision-making is also interdependent – financial actors must take into consideration not only their own views, but also how other competitors will make decisions about states. As a result, market actors have several incentives to reallocate resources based on information that damages a country’s reputation. When this process occurs, it can be a powerful driver for policy change.

7.2 Findings: Reputation and Market Enforcement as Drivers of Counter-Terrorism Cooperation

I find strong support for my theory in my analysis of international cooperation on combating terrorist financing. When the Financial Action Task Force (FATF) adds a country to its non-complier list, this small act imposes a large reputational penalty on the state. Investors charge a premium for debt from listed countries and cross-border bank flows to these destinations decline. To analyze this relationship, I use a quasi-experimental quantitative approach that addresses concerns about endogeneity by exploiting the unexpected introduction of new listing procedures in 2009. I compare similar countries that ended up just above or just below the eligibility threshold for listing. Within this group of countries, I show that listing leads
to lower cross-border bank flows. A non-instrumented regression analysis indicates listing is also correlated with increased sovereign spreads, suggesting investors view listed countries as riskier investments. Qualitative evidence from interviews and newspaper reporting supports these findings, confirming that market actors view listed countries as higher risk.

The FATF non-complier list’s ability to damage the reputations of non-compliant states leads not only to market enforcement, but to significant and widespread policy change. Listed countries are nearly 5 times more likely to adopt FATF-compliant laws on terrorist financing, compared to non-listed countries. These new laws are often quite controversial domestically, as governments may have competing political priorities or face outright opposition over financial regulation or new anti-terrorism legislation. But governments make the changes because they want to improve their reputations internationally. Interviews with officials from formerly listed countries and press reporting highlight the importance of reputational concerns for driving policy change; indeed, political leaders often justify more stringent legislation as necessary to improve their countries’ reputations in financial markets.

My analysis also shows how, because of reputational concerns, markets intensify the effect of listing on policy change. Listed countries with high levels of market integration are more likely to adopt FATF-compliant laws on terrorist financing in a given period, compared to listed countries with low levels of market integration and compared to non-listed countries. When a country is more integrated into international financial networks – either through cross-border banking relationships or sovereign debt markets – its policymakers are more likely to be responsive to the reputational costs of listing. Qualitative evidence illuminates this mechanism, as the FATF list causes central banks and private domestic banks to become advocates for policy change. My case study of Thailand further illustrates this relationship, highlighting how the process of market enforcement led the Thai banking community, central bank, and private sector to become key allies for improved FATF compliance.

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My empirical analysis is able to test several of the specific claims of my reputational theory through within-case comparisons. I find strong support for the notion that the characteristics of the information provider – in this case, the FATF – matter for how monitoring affects country reputation. Interviews with IO and government officials and participant observation at several FATF global network meetings confirm that the FATF is a highly technical, mostly apolitical body, and that this enhances its credibility and legitimacy among a wide range of audiences. As the focal institution in this issue area, the FATF was already well-known to the global banking sector and to some types of investors prior to the creation of the non-complier list. When the FATF began to issue its new list, these market actors had systems in place to integrate the new information into their decision-making processes. In contrast, although the US government produces its own annual list of countries of financial integrity concern, there is no evidence that this list leads to an equivalent level of reputational damage or financial repercussions.

The specifics of my case also highlight the importance of how an institution conveys its findings about non-compliance, and the relevance of second-order beliefs. The FATF has maintained robust monitoring procedures for decades, and even before the creation of the non-complier list, it published detailed reports on non-compliant state behavior. Yet market actors were largely unresponsive to such reports. And while states rushed to change their laws in advance of monitoring, governments made few policy changes after the final reports were published. Since 2010, however, the FATF has used these long, detailed reports to decide whether countries are eligible for listing. When the FATF lists a country, it provides very little information on deficiencies and government action. Yet this latter signal is much more powerful for generating reputational consequences because it affects second-order beliefs, and for markets, decision-making is inherently interdependent.

My findings also illustrate the necessity of having information align with the priorities of a specific audience, in order for new information to generate reputational effects. Prior to
the FATF non-complier list, global banks and financial institutions, as well as some IOs, had incentives to consider a country’s overall risk of money laundering and terrorist financing. Yet it was difficult for these actors to use FATF monitoring reports to assess such risk. In the third-round monitoring reports (2005-2014), the FATF rated compliance and justified its rating for each of the 49 recommendations, but it did not provide any overall score or aggregate rating for the country, nor did it clearly identify the highest-risk countries. As a result, banks and financial institutions were left to interpret information on their own. Once the FATF established the non-complier list, which identified deficient and high-risk jurisdictions, however, it provided information that more clearly aligned with the priorities of market actors. And as governments around the world began to levy large fines against banks that violated general laws on financial integrity, the information provided by the FATF non-complier list and market actor priorities moved closer together.

7.3 Theoretical Contributions

This dissertation contributes to the literature on international cooperation, reputation, and compliance by emphasizing the significance of information in generating reputational effects and leading to third-party enforcement. Previous scholarship has recognized that informational asymmetries abound in international politics, and as a result, reputation is important for deterrence and bargaining (Schelling, 1966; Jervis, 1976; Powell, 1990), as well as international cooperation (Keohane, 1984; Tomz, 2007). But such accounts have typically focused on a causal process where a state’s behavior drives its reputation, which in turn, drives future outcomes. My analysis problematizes this causal chain, emphasizing that how actors learn about state behavior can be as important as the behavior itself. The source of information, the way information is provided, and the degree to which information aligns with the incentives of a specific audience all affect whether information generates reputational consequences for uncooperative states.
In drawing attention to the source and content of information, I build on an emerging literature on global performance assessments, whereby information is conveyed in a way that facilitates comparative judgments across states (Kelley and Simmons, 2017). Recent work by Judith Kelley (2017) focuses specifically on how this type of comparative grading is effective for damaging the reputations of states in realm of human trafficking. Kelley offers a detailed theory whereby reputational damage is most likely to generate behavioral change when governments are sensitive to and exposed to reputational damage, and when a government prioritizes its reputation in a particular issue area. But while this account highlights the complexity of reputation across issue areas, it leaves relatively unexplored the question of under what conditions institutions or actors can change the fundamental role of reputation on a given topic. My theory fills this gap, highlighting how the characteristics of the monitor and the form of information matter significantly for its ability to generate reputational effects. More importantly, my theory’s emphasis on second-order beliefs suggests a testable implication for when governments should be most responsive to reputational pressures: when information aligns closely with a specific audience’s priorities, and when actors in this audience engage in interdependent decision-making.

Perhaps the most significant contribution of my theory is to suggest that reputational consequences, on their own, are generally insufficient to drive widespread policy change. Instead, my theory draws attention to the audience for information and whether these actors have significant resources at their disposal. In this way, I bridge the gap between informational analyses of ratings and rankings, which often focus on the normative aspects of such monitoring, and enforcement school theorists who emphasize the significance of coercive pressure. Following Tomz (2007), I argue that reputation matters, even to rational economic actors like banks and investors. I differ from Tomz, however, by arguing that the acquisition of information about state behavior is not so straightforward. Market actors rarely observe a state’s specific behavior; instead, they learn about a government’s history and objectives
from different types of monitoring reports. As a result, the source and format of information can be as important as the specific details about state behavior. And integrating information in this manner can be the result of a purely rational calculation, because market decision-making is interdependent, and therefore banks and investors must take into account how others will respond to new information.

Within the realm of international political economy (IPE), my findings draw attention to an important but understudied area of international finance: cross-border bank flows. Trade, foreign direct investment, remittances, sovereign bond yields – all of these areas of IPE rely on cross-border banking relationships to facilitate transactions. Without correspondent banking relationships to convert local currencies to US dollars, or provide financing for exporters and importers, many types of trade and finance would break down. This dissertation suggests that the banking network underlying key areas of globalization is actually much more subject to disruption that scholars have typically assumed.

My findings also highlight the advantages of bringing an IPE framework to the analysis of security policy. IPE scholars have highlighted how globalization and institutionalization activates domestic interest groups in favor of or in opposition to economic openness (Milner, 1997; Goldstein and Martin, 2000; Mansfield, Milner and Rosendorff, 2002; Davis, 2012). Recent work suggests interdependence between states leads to rule overlap and potential conflict, while also providing opportunities for transnational policy alliances (Buthe and Mattli, 2011; Farrell and Newman, 2016). My analysis builds on this literature, suggesting that economic interconnectedness between banks leads to higher levels of domestic support for more stringent banking regulation. But because global banking is now linked to security cooperation on combating money laundering and terrorist financing, economic interdependence has also driven tougher security policies and strengthened bureaucracy in these areas.

This dissertation also makes several empirical contributions. With new data that draws from legal documents, international organization reports, newspapers, and interviews, I pro-
vide the first detailed cross-national analysis of policy change in the realm of terrorist financ-

ing. This issue area is considered the cornerstone of international cooperation on combating 
terrorism, which is arguably the most pressing security issue for today’s global community. 
My specific case study of the FATF also has several empirical advantages, which allow me 
to test how the source and form of information matter in generating reputational effects. 
Perhaps most significantly, unlike many previous studies of international institutions, I am 
to address concerns about endogeneity through the use of a regression discontinuity design. 
This approach allows me to obtain a more precise estimate for how listing affects country rep-
utations in financial markets. I then build on this analysis with non-instrumented analyses 
to show the effect of listing on policy change.

7.4 Policy Implications

The arguments in this dissertation are significant for policymakers as well as for scholars 
of international relations. International institutions regulate many aspects of state policy, 
requiring ever deepening levels of regulatory harmonization and policy change. As the inter-
national community seeks solutions to transnational threats like climate change and global 
pandemics, policymakers confront the problem of how to deal with states that are unable 
or unwilling to cooperate. In some issue areas, the international community has learned to 
tolerate weak compliance. When the problem is a transnational threat that produces global 
vulnerabilities, however, non-compliance by a handful of states can undermine international 
cooperation as a whole. Seventy years ago, when the modern international system was first 
set up, the United States held such a preponderance of power that it could design and create 
its own global rules, or pressure actors bilaterally to change their policies. But in today’s 
multipolar era, unilateral domination by the United States or any other country is unlikely

3Previous scholarship has analyzed the diffusion of general counter-terrorism law [Pokalova 2015; Shor 2017]
to produce widespread policy change. Moreover, the current political climate in the United States makes it increasingly likely that the global leaders may need to address transnational threats without explicit assistance from the United States.

How, then, is the international community to respond to such challenges? This dissertation suggests institutional monitoring and assessment offers one possible solution. FATF members drew on the organization’s technocratic monitoring process to create a new list of non-compliant states. While the process of listing states is still subject to underlying political dynamics, institutional delegation and technocratic prowess have ensured that the FATF’s list still imposes reputational consequences on listed states. States, IOs, and non-state actors looking to drive policy change in other issue areas can learn from this approach – intergovernmental bureaucratic organizations that use highly technocratic criteria to identify non-compliance may be more likely to generate reputational effects. Equally important is how the institution works to convey its findings. Quantifying state policy through ratings, rankings, or a blacklist reduces uncertainty for outside observers, making it easier for actors to punish non-compliant states.

Of course, information itself is insufficient to motivate policy change; instead, a monitor needs to target information toward an audience with preferences that align closely to the monitor’s priorities. Audiences with unidimensional decision frameworks and interdependent decision-making are particularly strong targets for monitoring reports. While this project highlights how market actors like banks and investors are powerful audiences for reputational damage, policymakers might also target information toward other actors with similar characteristics. Companies, for example, often in invest in business operations or assets overseas, which can be impacted in similar ways by riskier or less reliable governments. Monitors may even target information toward the citizens of certain countries, although such efforts are only likely to be effective if a domestic population has a single decision criteria for judging a foreign government and if attitudes translate into political outcomes.
One of the key insights from international cooperation on combating terrorist financing is that international actors can also create demand for information through action that consolidates audience preferences. Outside observers might think that demand for information about the terrorist financing risk of different countries was created by the exogenous shock of 9/11. In fact, however, while the 9/11 terrorist attacks increased cooperation, most countries did not introduce strong financial regulations on monitoring or impeding risky transactions with other countries until nearly a decade later. While demand for information existed prior to the list, market actors could solicit information in a variety of ways and, as a result, ignore certain signals. But once the FATF list entered the informational arena, the signal became a focal point for all other informational efforts. It thus responded to, but also created, informational demand.

This nuance is significant because it suggests the international community may be able to generate demand for information in areas where preferences are currently too diverse for reputation to drive significant policy change. Such a process might occur through either changes in institutional or government regulation or through the entrance of a large funder with unidimensional preferences into a specific market. In the institutional realm, international organizations may consider creating demand for information on state behavior through regulatory harmonization prior to providing any such information. In the FATF case, this sequencing may help explain the institution’s success. Absent strong institutionalized cooperation, regional blocks or a small number of strong economies may generate demand for information through harmonized domestic regulation. Finally, in issue areas where states are slow to act, private actors like foundations may be able to create demand by providing funding in a way that reorients non-governmental organization priorities along more consolidated lines.

My findings also have important policy implications for practitioners working on international efforts to protect the integrity of the financial system: the form of monitoring
matters. For years, the FATF and its global affiliates were producing detailed monitoring reports without sending any clear or concise signal about the actual level of money laundering or terrorist financing risk in monitored countries. Such monitoring efforts undoubtedly improved compliance, but created few reputational costs for non-compliant states. As a result, countries where policy change was financially or politically costly failed to improve their policies. The introduction of the non-complier list, however, changed this calculation for governments, increasing the costs of continued non-compliance. This list is likely to continue to be a powerful driver of policy change as long as the institution remains a credible and legitimate source of information; for this reason, policymakers should oppose changes that would increase direct state control over the monitoring process. Policymakers should also be careful in considering deregulation of the financial sector. Weakening the requirement for US banks to consider a customer’s financial integrity risk, for example, would not only decrease US compliance with FATF standards, it would lessen the reputational costs associated with the FATF non-complier list. As a result, listed states would be less likely to change their laws to combat money laundering and terrorist financing. Effectively, deregulation of US finance would weaken global security cooperation efforts, with potential implications for counter-terrorism and anti-crime efforts worldwide.

7.5 Extensions

This dissertation has implications for how we understand the role of reputation in international cooperation. Existing research has demonstrated that reputational concerns can motivate many different types of state behavior, and that certain types of information are more effective at generating reputational consequences. Yet the precise conditions that connect information to reputational damage, and reputational damage to significant policy change remain underspecified. Who monitors and how do they convey information? Who receives it, and how does the information align with this audience’s decision criteria? Answering these
questions is essential for policymakers seeking to drive widespread policy change, and for international relations scholars seeking to understand the role of reputation in international politics.

This dissertation is a step toward specifying such conditions. The first part of the theory suggests that information about unsavory state behavior can damage a country’s reputation when it is credible and precise. Building on these insights, future scholarship might probe how the source and form of information about state behavior affects other areas of international politics. Such research need not be just confined to the study of ratings, rankings, and indicators. Scholars might also compare the relative impact of similar types of monitoring reports produced by different types of actors, or trace how changes within an institution’s monitoring process affect its ability to generate reputational effects.

New information is particularly likely to lead to reputational damage when the targeted audience uses second-order beliefs to guide decision-making. Scholars interesting in finding the strongest reputational effects might examine other issue areas where actors engage in interdependent decision-making. Foreign direct investment, for example, is more likely to be responsive to reputation than development aid, since companies looking to invest overseas must also take into consideration the decisions of their competitors. Given that a number of state and non-state actors monitor and rate overseas business climates, scholars might compare different monitoring schemes to understand the conditions under which audiences respond to new information. Experimental research probing the micro-foundations of the relationship between the identity of the monitor, the information type, and the audience’s decision-set might also yield fruitful insights.

Of course, information and reputation are only half of the theory; for reputational consequences to translate into widespread policy change, there must be some type of third-party actor willing to reallocate significant resources away from non-compliant states. This latter scope condition is a key part of the story. Without material repercussions, reputation can
still matter, but it will not drive massive improvements in compliance or major policy change. Future research could search for similar enforcement processes in the context of international monetary or trade commitments. Ongoing cooperation in the environmental realm might also yield examples of information about country behavior damaging reputations and leading to third-party enforcement. Scholars could also examine more narrowly-targeted regulatory agreements, where information often aligns directly with the interests of a small, but consolidated group of actors. Regardless of issue area, this dissertation suggests future work on reputation and compliance should direct attention to non-state actors rather than states. In today’s interconnected environment, transnational forces that bridge the gap between states are likely to be the most powerful motivators for policy change.
A.1 Interviews by Author

I have conducted numerous interviews over the course of this project, some of which informed my analysis but were not directly cited in this paper. A list of all interviews, both cited and un-cited, is provided below.

- Interview with UN Security Council Secretariat official, 15 March 2012
- Interview with FATF official, 6 May 2014
- Interview with FATF official, 6 May 2014
- Interview with UNODC official, 7 May 2014
- Interview with UNODC official, 8 May 2014
- Interview with UNODC official, 8 May 2014
- Interview with Executive Director of a FATF regional body, 10 December 2014
- Interview with official from a FATF regional body, 27 January 2015
- Interview with official from FATF regional body, 17 February 2015
- Interview with Citibank official, 28 August 2015
- Interview with official from compliance company, 22 September 2015
- Interview with official from compliance company, 24 September 2015
- Interview with MSCI official, 25 September 2015
- Interview with Credit Agricole CIB official, 25 September 2015
- Interview with official from Thomson-Reuters World-Check, 28 September 2015
- Interview with official from Thomson-Reuters Country-Check, 29 September 2015
- Interview with investment firm official, 8 February 2016
- Interview with official from formerly listed country, 9 February 2016
- Interview with official from a private bank in Ethiopia, 11 February 2016
- Interview with Thai government official, 14 February 2016
- Interview with official from an international development bank, 7 April 2016
- Interview with official from FATF regional body, 30 June 2016
• Interview with Executive Director of a FATF regional body, 30 June 2016
• Participant Observation of Asia-Pacific Group Plenary, 6-8 September 2016
• Interview with Thai banking official, 9 March 2017
• Interview with former FATF President Antonio Gustavo Rodrigues, 29 March 2017
• Participant Observation of MONEYVAL Plenary, 30 May - 1 June 2017
### A.2 FATF Members and Associate Members

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

Table A.1: 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.
A.3 FATF 16 Key & 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, a FATF regional body 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” (Interview, 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)
## A.4 FATF Non-Complier List Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Listed</th>
<th>Graduated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Afghanistan</td>
<td>2012</td>
<td>–</td>
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<tr>
<td>Albania</td>
<td>2012</td>
<td>2015</td>
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<tr>
<td>Algeria</td>
<td>2011</td>
<td>2016</td>
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<tr>
<td>Angola</td>
<td>2010</td>
<td>2016</td>
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<tr>
<td>Antigua and Barbuda</td>
<td>2010</td>
<td>2014</td>
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<tr>
<td>Argentina</td>
<td>2011</td>
<td>2014</td>
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<tr>
<td>Azerbaijan</td>
<td>2010</td>
<td>2010</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>2010</td>
<td>2014</td>
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<tr>
<td>Bolivia</td>
<td>2010</td>
<td>2013</td>
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<tr>
<td>Bosnia-Herzegovina</td>
<td>2015</td>
<td></td>
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<tr>
<td>Brunei Darussalam</td>
<td>2011</td>
<td>2013</td>
</tr>
<tr>
<td>Cambodia</td>
<td>2011</td>
<td>2015</td>
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<tr>
<td>Cuba</td>
<td>2011</td>
<td>2014</td>
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<tr>
<td>DPRK</td>
<td>2007</td>
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<td>Ecuador</td>
<td>2010</td>
<td>2015</td>
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<tr>
<td>Ethiopia</td>
<td>2010</td>
<td>2014</td>
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<tr>
<td>Ghana</td>
<td>2010</td>
<td>2013</td>
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<tr>
<td>Greece</td>
<td>2010</td>
<td>2011</td>
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<tr>
<td>Guyana</td>
<td>2014</td>
<td></td>
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<tr>
<td>Honduras</td>
<td>2010</td>
<td>2012</td>
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<tr>
<td>Indonesia</td>
<td>2010</td>
<td>2015</td>
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<tr>
<td>Iran</td>
<td>2007</td>
<td>–</td>
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<tr>
<td>Iraq</td>
<td>2013</td>
<td>–</td>
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<tr>
<td>Kenya</td>
<td>2010</td>
<td>2014</td>
</tr>
<tr>
<td>Kuwait</td>
<td>2012</td>
<td>2015</td>
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<tr>
<td>Kyrgyzstan</td>
<td>2011</td>
<td>2014</td>
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<tr>
<td>Lao PDR</td>
<td>2013</td>
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<td>Mongolia</td>
<td>2011</td>
<td>2014</td>
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<td>Morocco</td>
<td>2010</td>
<td>2013</td>
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<td>Myanmar</td>
<td>2010</td>
<td>2016</td>
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<tr>
<td>Namibia</td>
<td>2011</td>
<td>2015</td>
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<td>Nepal</td>
<td>2010</td>
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<td>Nicaragua</td>
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<td>2015</td>
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<td>Nigeria</td>
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<td>Pakistan</td>
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<td>2015</td>
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<tr>
<td>Panama</td>
<td>2014</td>
<td>2016</td>
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<tr>
<td>Papua New Guinea</td>
<td>2014</td>
<td>2016</td>
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<tr>
<td>Paraguay</td>
<td>2010</td>
<td>2012</td>
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<tr>
<td>Philippines</td>
<td>2010</td>
<td>2013</td>
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<tr>
<td>Qatar</td>
<td>2010</td>
<td>2010</td>
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<tr>
<td>Sao Tome and Principe</td>
<td>2010</td>
<td>2013</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>2010</td>
<td>2013</td>
</tr>
<tr>
<td>Sudan</td>
<td>2010</td>
<td>2015</td>
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<tr>
<td>Syria</td>
<td>2010</td>
<td></td>
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<tr>
<td>Tajikistan</td>
<td>2011</td>
<td>2014</td>
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<tr>
<td>Tanzania</td>
<td>2010</td>
<td>2014</td>
</tr>
<tr>
<td>Thailand</td>
<td>2010</td>
<td>2013</td>
</tr>
<tr>
<td>Trinidad and Tobago</td>
<td>2010</td>
<td>2012</td>
</tr>
<tr>
<td>Turkey</td>
<td>2010</td>
<td>2014</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>2010</td>
<td>2012</td>
</tr>
<tr>
<td>Uganda</td>
<td>2014</td>
<td></td>
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<tr>
<td>Ukraine</td>
<td>2010</td>
<td>2011</td>
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<tr>
<td>Vanuatu</td>
<td>2016</td>
<td></td>
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<tr>
<td>Venezuela</td>
<td>2010</td>
<td>2013</td>
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<tr>
<td>Vietnam</td>
<td>2010</td>
<td>2014</td>
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<tr>
<td>Yemen</td>
<td>2010</td>
<td></td>
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<tr>
<td>Zimbabwe</td>
<td>2011</td>
<td>2015</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>57</td>
<td>46</td>
</tr>
</tbody>
</table>

Table A.2: Countries listed by the FATF (Feb 2010 - June 2016) - Table shows the countries included on the non-complier list, the year of listing, 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).
Appendix B

Additional Information on Chapter 4
## B.1 FATF Reports: Compliance Comparison

<table>
<thead>
<tr>
<th>Country</th>
<th>Rating</th>
<th>Justification for Rating in Mutual Evaluation Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andorra</td>
<td>LC</td>
<td>Andorra is able to provide extensive assistance in the areas covered by recommendations 36 to 37. The strengths and weaknesses of the arrangements have been discussed. The ability to cooperate is considerably affected by the fact that terrorist financing is not fully established as an offense.</td>
</tr>
<tr>
<td>Bahrain</td>
<td>LC</td>
<td>No FT offense, so no extradition possible. No statistics received on mutual legal assistance so efficiency could not be properly assessed.</td>
</tr>
<tr>
<td>China</td>
<td>LC</td>
<td>The partial coverage of the TF offense constitutes an impeding element when the dual criminality principle is applied in relation to a foreign MLA request. The incomplete coverage of the TF offense may affect the legal capacity of China to comply with an extradition offense.</td>
</tr>
<tr>
<td>Mauritius</td>
<td>LC</td>
<td>There is a concern about the ability of Mauritian authorities to handle requests related to the financing of terrorism in a timely and effective manner.</td>
</tr>
<tr>
<td>Tunisia</td>
<td>LC</td>
<td>No means of determining the most appropriate venue for prospection in cases subject to prosecution in multiple countries. No provision for coordinating the seizure of assets with foreign authorities. Inability of financial sector supervision agencies to participate in international cooperation.</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>LC</td>
<td>Recently enacted legislation and therefore implementation cannot be assessed. No statistics available to assess effectiveness.</td>
</tr>
<tr>
<td>Barbados</td>
<td>PC</td>
<td>Range of mutual legal assistance does not include instrumentalties of TF. No provision for foreign states to apply for freezing or confiscation.</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>PC</td>
<td>Lack of TF offense hampers mutual legal assistance and extradition requests from being answered; No specific procedures ensuring timely consideration of MLA requests.</td>
</tr>
<tr>
<td>Malawi</td>
<td>PC</td>
<td>No clear and efficient processes for executing requests. Insufficient implementation of the provisions relating to TF cases.</td>
</tr>
<tr>
<td>Mexico</td>
<td>PC</td>
<td>The deficiencies in the TF offense impact on Mexico’s ability to provide international cooperation through MLA and extraditions.</td>
</tr>
<tr>
<td>Monaco*</td>
<td>PC</td>
<td>Unable to provide full mutual assistance for the financing of a terrorist organization or individual; Information on cooperation between supervisory authorities does not make it possible to judge effectiveness.</td>
</tr>
<tr>
<td>Senegal</td>
<td>PC</td>
<td>No implementation of the international legal instruments and elements for assessing the effectiveness of the cooperation.</td>
</tr>
<tr>
<td>Slovakia</td>
<td>PC</td>
<td>Financing of terrorism is not an independent offense in Slovakia and many elements are not covered, such as to raise problems for mutual legal assistance when applied to terrorist financing. There are no special provisions concerning mutual legal assistance in relation to financing of terrorism offenses.</td>
</tr>
<tr>
<td>Turkey</td>
<td>PC</td>
<td>The limited scope of the TF offense could present grounds to refuse extradition request or mutual legal assistance if request relates to terrorism not involving Turkey or its interests.</td>
</tr>
<tr>
<td>Bolivia*</td>
<td>NC</td>
<td>Financing of terrorism is not criminalized, and so there is no evidence that the country could lend mutual legal assistance or exchange information in cases related to the financing of terrorism, beyond the desire to do so on part of the interviewed authorities.</td>
</tr>
</tbody>
</table>

Table B.1: FATF Mutual Evaluation Reports - Rating Comparison on SR.V The table compares how FATF assessment teams rated country compliance with Special Recommendation V (International Cooperation). The chart shows the country, year of the mutual evaluation report, rating, and justification for all non-FATF countries that received failing scores on 9 or 10 of the 16 key and core recommendations prior to 2009. The text from the Bolivia mutual evaluation report is translated from Spanish, and the text from the Monaco mutual evaluation report is translated from French.
## B.2 Placebo Test

<table>
<thead>
<tr>
<th></th>
<th>Dependent variable:</th>
<th>Listing</th>
<th>Cross-Border Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>OLS</td>
<td>2SLS</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(1)</td>
<td>(2)</td>
</tr>
<tr>
<td>11+ Failing Recommendations</td>
<td>0.074**</td>
<td>(0.036)</td>
<td></td>
</tr>
<tr>
<td>Listing</td>
<td></td>
<td></td>
<td>-0.464</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(2.513)</td>
</tr>
<tr>
<td>Observations</td>
<td>357</td>
<td>357</td>
<td></td>
</tr>
<tr>
<td>Countries</td>
<td>21</td>
<td>21</td>
<td></td>
</tr>
<tr>
<td>F Statistic</td>
<td>4.332</td>
<td>4.332</td>
<td></td>
</tr>
</tbody>
</table>

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

Table B.2: Placebo Test: Effect of Listing on Cross-Border Liabilities - Model 1 an OLS regression estimating the effect of 11+ failing recommendations on the probability of listing. Model 2 is a 2SLS regression estimating the effect of listing on cross-border liabilities. Standard errors clustered by country, listing period, and the number of failing recommendations.
### B.3 Conditional Ignorability Assumption

<table>
<thead>
<tr>
<th>Variable</th>
<th>Correlation: # of Failing Recs</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>−0.103</td>
</tr>
<tr>
<td>GDP per capita</td>
<td>−0.163</td>
</tr>
<tr>
<td>Financial Account</td>
<td>−0.041</td>
</tr>
<tr>
<td>FDI</td>
<td>−0.047</td>
</tr>
<tr>
<td>Number of Banks</td>
<td>−0.012</td>
</tr>
<tr>
<td>Cross-border Liabilities</td>
<td>−0.014</td>
</tr>
<tr>
<td>Cross-border Claims</td>
<td>−0.017</td>
</tr>
<tr>
<td>Democracy</td>
<td>−0.053</td>
</tr>
<tr>
<td>Terrorism</td>
<td>−0.172</td>
</tr>
</tbody>
</table>

Table B.3: The table shows the correlation between the number of failing recommendations and key economic and political variables for all non-FATF member countries that had been evaluated by the FATF as of June 2009. Data for variables is from the year 2010.


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