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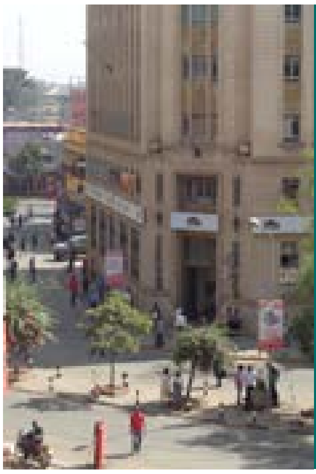


Capital flight and the financial system

Isabella Massa

Abstract

Capital flight has become an increasing source of concern for policy makers in developing countries, including African economies, since it represents a severe constraint for growth and development. This paper analyzes how the domestic and global financial system may facilitate capital flight from Africa. We argue that on the domestic side, a high presence of foreign banks and underdeveloped financial markets; weak banking regulatory and supervisory frameworks; capital controls; and the take-off of mobile banking are some of the factors that may be conducive to capital flight. On the other hand, the global financial system may facilitate capital flight through banking secrecy, business in secrecy jurisdictions, and financial innovation (new payment methods, financial derivatives, hedge funds, private equity funds). Bank secrecy laws and financial activities in secrecy jurisdictions also represent an important obstacle for capital flight repatriation to Africa. In the paper, policy responses adopted at both the international and national level to prevent and combat capital flight and promote asset recovery are investigated. The analysis suggests that the effectiveness of such policy measures is far from satisfactory. This is due to a number of factors, which include, but are not limited to: (1) the lack of political will at both the African and global level; (2) weaknesses of the initiatives promoted at the international level, such as the lack of legal enforcement mechanisms, scarce credibility, and limited involvement of African countries; (3) the existence in Africa of regulatory loopholes, weak governance, and low levels of expertise and knowledge; (4) the lack of collaboration between local and foreign authorities; (5) differences in the legal systems of African economies and foreign countries; and (6) the lack of a universally recognized institutional body for global governance.

Introduction

Capital flight has become an increasing source of concern for policy makers in developing countries, as it implies a loss of resources that could be used to foster economic growth and development. The scale of the problem is huge. Kar and Freitas (2012) estimate that, because of capital flight, developing countries lost on average between US$586 billion to US$919 billion per annum over the period 2001–2010. In 2010, they lost from a minimum of US$859 billion up to US$1,138 billion. By way of comparison, net official development assistance (ODA) from members of the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) to developing countries was about US$129 billion in the same year, thus representing only 11 or 15 percent of the wealth that left poor countries through capital flight (OECD, 2011).

On a regional level, Africa in particular has been subject to injurious capital flight. Ndikumana et al. (2015) report that between 1970 and 2010, capital flight from 39 selected African countries (4 from North Africa and the rest from sub-Saharan Africa) reached a value of US$1.3 trillion in constant 2010 terms. This amount represents 82 percent of the combined GDP of the considered countries in 2010. The level of capital flight is very heterogeneous across African countries, with oil exporting countries such as Nigeria and Algeria experiencing some of the most dramatic amounts of capital flight in both absolute and relative terms (Ndikumana et al., 2015).

Although there is no widely accepted definition of capital flight, in this paper we refer to capital flight as illicit or illegal financial flows. A flow can be defined as illegal if the funds are the proceeds of an illegal activity, if the transfer itself is illicit, or if legal obligations relating to the fund are not adhered to (Reed and Fontana, 2011). Therefore, illicit financial flows may originate from a multitude of sources including corruption, crimes (drug or human trafficking), and tax evasion.[1]

But what are the features of the domestic and international financial system that facilitate capital flight from African countries? The literature on these issues is scarce, and this study aims to fill the gap. The analysis in this paper suggests that the financial sector should not be regarded as a passive player when analyzing capital flight. Indeed, there are several features of both the domestic and global financial system that may enable and encourage the flight of capital from Africa. On the domestic side, the existence of financial sectors characterized by a high presence of foreign banks as well as underdeveloped financial markets; the presence of weak banking regulatory and supervisory frameworks; the use of capital controls; and the take-off of mobile banking are some of the factors that may be conducive to capital flight. At the global level, the existence of bank secrecy laws and secrecy jurisdictions as well as the spread of innovative financial processes and unregulated financial products and institutions may also make it easier to move funds (especially illegal funds) from African countries.

The structure of the paper is as follows. Section 2 analyzes the features of the African domestic financial system that may facilitate capital flight. In Section 3, the focus of the analysis moves to the global financial system, specifically how it may encourage capital flight from Africa and make difficult the repatriation of stolen assets. Section 4 presents some of the policy responses adopted at both the international and national level to prevent capital flight from the African region and promote asset recovery. The weaknesses of such policies are discussed. Section 5 concludes and offers some policy recommendations.

1 See Ndikumana et al. (2015) for more details on the definition of illegal capital flight.

The domestic financial system and capital flight

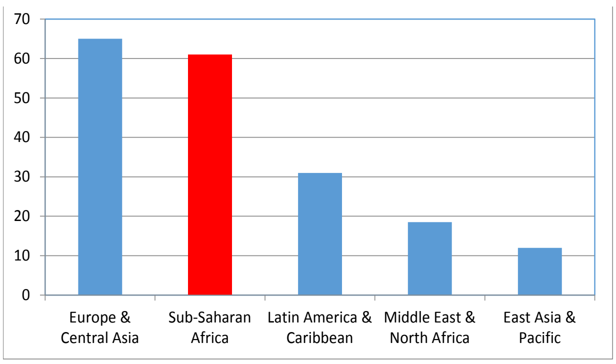
The domestic financial system in Africa is characterized by a number of features that may facilitate capital flight. These are related to the structure and functioning of the financial sector, the scope and effectiveness of financial regulation and supervision, the linkages between the domestic financial system and the global financial system, as well as to progress in financial innovation.

High presence of foreign banks

The financial systems in many African countries are dominated by local banks and branches or subsidiaries of foreign banks. The latter have increased significantly over the last decades, especially in sub-Saharan Africa (SSA) where foreign banks acquired a significant market share when local banking systems were restructured and state owned banks were privatized under several reform programs in the 1980s and 1990s. Currently, the degree of foreign ownership of banks in SSA is only second to that of Europe and Central Asia, and higher than that in all other developing regions (Figure 1). The most recent available data shed light on two key facts. First, the biggest share of foreign banks in SSA belongs to western economies (61%) (Figure 2). Second, the percentage of foreign banks with respect to total banks operating within SSA countries is very heterogeneous across countries. Indeed, some economies such as Burkina Faso, Madagascar, and Zambia have their banking systems entirely owned and managed by foreign banks, while in countries such as South Africa, Nigeria, and Ethiopia there is a minimal or no share of foreign banks (Figure 3).

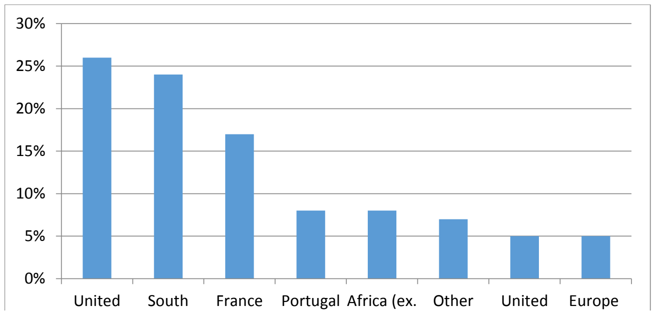
The high presence of foreign banks in Africa is likely to be conducive to capital flight, although the existing evidence is still scarce and to some extent contradictory. Mathieson and Roldos (2001), for example, argue that the presence of foreign banks leads to what has been defined as "capital flight at home." In other words, local residents generally perceive branches or subsidiaries of foreign banks as safer than domestic banks, since the former have the external support of their parent banks. Therefore, they may find it attractive to shift their deposits from domestic banks to foreign banks in their country instead of engaging in capital flight abroad. Nevertheless, it is worth highlighting that foreign banks have several investment opportunities outside the host country, so they may easily reallocate local funds abroad in search of better investment opportunities, especially when conditions of the host country worsen. In such a way, they facilitate the flight of capital. Branches or subsidiaries of foreign banks may also make it easier to move abroad illegally acquired local funds. Episodic evidence, indeed, shows that some branches or subsidiaries of foreign banks in Africa have been used by dictators or corrupt government officials to divert illicit funds to accounts in Western economies and tax havens. For example, Omar Bongo, the former president of Gabon, exploited the Citibank network to open an initial account in Libreville (Gabon) that allowed him to obtain several

Figure 1. Share of foreign bank assets (% of total bank assets) by region, 2009



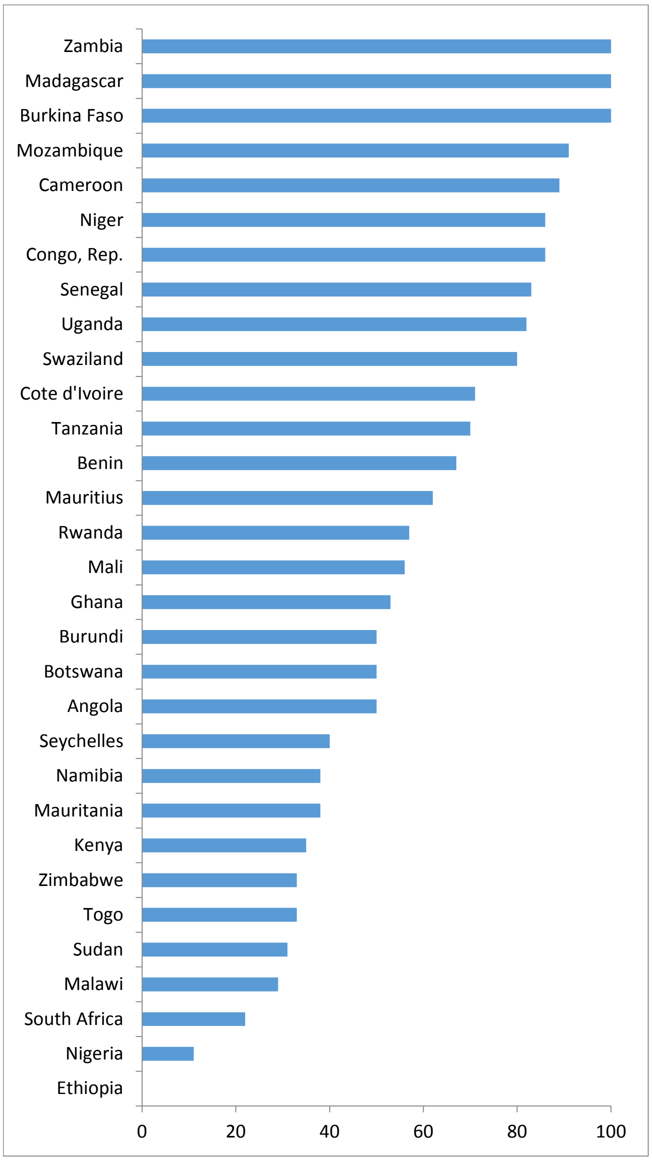
Source: World Bank, Global Financial Development Database.

Figure 2. Home countries of foreign banks in SSA, 2000-06



Source: Author's calculations using Word Bank (2008).

Figure 3. Share of foreign banks (% of total banks) in SSA, 2009



Source: World Bank, Global Financial Development Database.

other Citibank accounts abroad (e.g., in Bahrain, New York, Paris, and Switzerland) under the name of various fake persons and societies.[2] In this way he and his family were able to use illegally acquired funds in and out of their own country. This is just one of several examples of how branches or subsidiaries of foreign banks have been used to move, manage, and launder illicit flows from Africa and other developing regions.

Figure 4 compares the percentage of foreign banks among total banks with the level of capital flight as a share of GDP for a selected number of African countries. From the figure it emerges that there is a positive albeit weak correlation between foreign banks' presence and capital flight. Some countries such as Cote d'Ivoire and Mozambique are characterized by high levels of capital flight and their banking systems are dominated by foreign-owned banks. On the other hand, there are countries such as Nigeria that have a low share of foreign banks but experience high capital flight.

Underdeveloped stock, bond, and derivative markets

Stock exchanges in Africa have proliferated over the last two decades, rising from just 8 in the 1990s (5 in SSA and 3 in North Africa) to about 20 nowadays (Massa, 2009; Allen et al., 2010). Nevertheless, most African stock markets are still underdeveloped and face serious challenges in terms of depth, liquidity, and operational efficiency. Indeed, depth measures such as market capitalization as a share of GDP show that stock markets in Africa are very small, with the exception of those in a few countries such as South Africa, Morocco, Egypt, and Kenya (Table 1). In a similar way, the two standard measures of stock market liquidity —total value of stocks traded as a percentage of GDP, and turnover ratio—point out that African stock markets tend to be illiquid and thin, again with the exception of South Africa and Egypt (Table 1).

In addition to this, the use of manual rather than automated trading and clearing systems in most African stock exchanges makes these markets operationally inefficient (Table 2).

Bond markets are also not well developed in the majority of African countries, although they have been steadily growing in recent years (Allen et al., 2010; Mu et al., 2013). Primary government bond markets have been established in a number of economies and are fairly well developed in countries such as Egypt, Morocco, Tunisia, Kenya, South Africa, Botswana, and Zambia, among others. Nevertheless, with the exception of South Africa, corporate bond markets are much less developed.

The derivative market is still non-existent or in its infancy in most African economies. Indeed, financial derivatives are traded only in a few Southern African countries such as South Africa, Botswana, Namibia, and the Seychelles. In Morocco, futures markets based on treasury bonds opened in 2008, while derivative markets are in the early stages of development in West Africa (Allen et al., 2010).

The limited development of domestic financial markets may lead to capital flight. Indeed, if the financial market of a given country provides only a limited variety of

2 See http://www.lexpress.fr/actualite/monde/afrique/les-faramineux-comptes-secrets-d-omar_497296.html

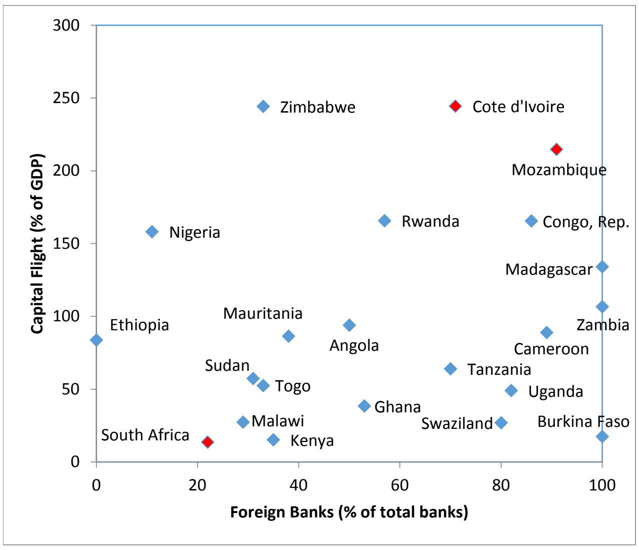
Table 1. Stock market development indicators of selected African countries, 2010

Country	Stock market capitalization to GDP (%)	Stock market total value traded to GDP (%)	Stock market turnover ratio (%)
Botswana	29.15	0.84	3.22
Cote d'Ivoire	28.07	0.56	2.05
Egypt, Arab Rep.	39.68	20.82	42.72
Ghana	9.50	0.25	3.33
Kenya	38.41	2.40	8.77
Malawi	24.57	0.36	1.51
Morocco	71.83	21.72	16.49
Nigeria	19.55	2.33	11.81
South Africa	252.59	102.08	37.03
Tunisia	21.73	3.25	17.68
Uganda	15.28	0.06	0.38
Zambia	17.97	0.94	8.85

Source: World Bank's Global Financial Development Database.

financial instruments in which wealth can be held, then it is expected that local investors will seek alternative countries where their assets will yield higher returns.[3] Recent data on capital flight in African countries reported by Ndikumana et al. (2015) seem to confirm this hypothesis. Indeed, economies characterized by more developed and sophisticated financial markets, such as those of

Figure 4. Foreign banks vs. capital flight in selected African countries



Sources: Author's elaboration usinng data from The World Bank's Global Financial Development Database, and Ndikumana et al. (2015).

Table 2. Automated vs. manual trading and clearing systems in selected African countries

Country	Clearing & Settlement	Trading system
Algeria	Electronic	Electronic
Botswana	Manual	Manual
Cote d'Ivoire	Electronic	Electronic
Egypt	Electronic	Electronic
Ghana	Manual	Manual
Kenya	Manual	Electronic
Malawi	Manual	Manual
Mauritius	Electronic	Electronic
Morocco	Manual	Electronic
Namibia	Manual	Electronic
Nigeria	Electronic	Electronic
South Africa	Electronic	Electronic
Swaziland	Manual	Manual
Tanzania	Electronic	Electronic
Tunisia	Electronic	Electronic
Uganda	Manual	Manual
Zambia	Electronic	Electronic
Zimbabwe	Manual	Manual

Source: Adapted from Allen et al. (2010).

South Africa, Egypt, Botswana, and Kenya, apparently experienced lower levels of capital flight as a share of GDP compared to their African peers with less developed financial markets.

Lack of (credible) deposit insurance protection systems

In the literature, the lack of full or credible deposit insurance on assets held in the domestic banking sector is recognized as one of the features of the domestic financial system that may lead to capital flight (Ajayi, 1992). This is due to the fact that if, in a given country, deposit insurance protection systems are inexistent, hardly credible, or highly ineffective, depositors may find it more attractive and safer to find opportunities to hold their wealth outside the country rather than deposit their money in domestic banks.

Data sourced from the World Bank's Bank Regulation and Supervision Database show that most African countries do not offer explicit depositor protection schemes (Table 3). A few exceptions are Algeria, Kenya, Morocco, Nigeria, and Sudan. Indeed, Algeria, Kenya, and Sudan have deposit protection funded by the government and banks, while in Morocco and Nigeria it is funded by the banks only. The extent to which a deposit protection fund covers depositors varies widely across countries. For example, in Algeria the fund covers up to US$10,000 while in Kenya it covers only up to US$1,333.

In order to check whether the lack of deposit insurance protection systems leads to higher levels of capital flight in Africa, we compare country data on the existence of depositor protection schemes with data on capital flight as reported by Ndikumana et al. (2015). Table 3 broadly confirms that countries with the highest levels of capital flight as a share of GDP, such as the Seychelles and Burundi, do not have deposit insurance protection systems. Interestingly, Algeria and Nigeria are characterized by high levels of capital flight as a share of GDP notwithstanding the existence of depositor protection schemes. This may be explained, among other factors, by the fact that these schemes are barely credible. Indeed, data reported by the World Bank's Bank Regulation and Supervision Database show that neither in Algeria nor in Nigeria were depositors wholly compensated the last time a domestic bank failed. Moreover, the average time to pay depositors in full appears to be particularly long in Nigeria (3 years). This is not the case in countries such as Kenya where capital flight as a share of GDP is lower compared to other countries, thanks to the existence of a credible depositor protection scheme, among other factors. In Kenya, indeed, data show that depositors were completely compensated the last time a bank failed, and the average time to pay depositors in full is just 1 year.

Table 3. Deposit insurance protection systems vs. capital flight in selected African countries

Country	Is there an explicit deposit insurance protection system?
Seychelles	No
Burundi	No
Congo	No
Côte d'Ivoire	No
Zimbabwe	No
Guinea Bissau	No
Gabon	No
Rwanda	No
Algeria	Yes
Nigeria	Yes
Central African Republic	No
Madagascar	No
Morocco	Yes
Cameroon	No
Tunisia	No
Sudan	Yes
Togo	No
Lesotho	No
Ghana	No
Guinea	No
Egypt	No
Swaziland	No
Botswana	No
Chad	No
Burkina Faso	No
Kenya	Yes
South Africa	No

Sources: Author's elaboration using the World Bank's Bank Regulation and Supervision Database, and Ndikumana et al. (2015).

Lack of independence of central banks

In several African countries, the central bank is the body in charge of supervising commercial banks for prudential reasons, and the prevention of capital flight (especially illegal capital flight) is part of its supervisory mandate.[4] However, the lack of independence of central banks from political powers may weaken their authority and their

3 Note, however, that an increased variety of financial instruments may also provide additional opportunities for illegal financial transactions, thus increasing capital flight. This may be the case for financial derivative products that are traded in unregulated markets (see Section 3).

capacity to impede the flight of capital. In the worst-case scenario, the central bank may even play an active role in facilitating capital flight. That was the case of Nigeria, where the central bank was subject to severe political interference. Indeed, General Sani Abacha, the *de facto* president of Nigeria from 1993 to 1998, ran the central bank as if it was his own private account. In collaboration with the Minister of Finance, Anthony Ani, and the Minister of Power and Steel, Bashir Dalhatu, he was able to divert US$2.5 billion from Nigeria's central bank to their private accounts in London.[5]

When dealing with the independence of central banks, it is important to distinguish between *legal* independence and *actual* independence. Cukierman et al. (1992) explain that legal independence refers to the degree of independence that legislators meant to confer on the central bank, and built an index of legal central bank independence taking into account factors such as the way governors of central banks are appointed and dismissed, their term in office, the way conflicts are solved between the executive body and the central bank, the degree of participation of the central bank in the formulation of monetary policy and in the budgetary process, the mandate of the central bank, and the legal restrictions on the ability of the public sector to borrow from the central bank (e.g., limitations on the volume, maturity, rates, and width of direct advances and of securitized lending to the public sector). The index goes from 0 (the lowest level of legal independence) to 1 (the highest level of independence). On the other hand, actual independence is the true power that central banks have or are willing to use within the economy. Although it is very difficult to measure, Cukierman et al. (1992) try to proxy actual independence using the turnover rate of central bank governors. A high turnover rate may reflect that the tenure of governors is somehow linked or overlapped with political elections and the time in office of the executive branch, so that the governor is likely to be less willing or capable to exert his authority in an independent way. The turnover ratio goes from 0.03 (average tenure of 33 years) to 0.93 (average tenure of 13 months), with the threshold being 0.2 (average turnover of 5 years). A turnover ratio above this threshold is interpreted as a scarcely independent central bank.

In Table 4 we list the various proxies for legal and actual independence for some of the African countries that, according to the World Bank's Bank Regulation and Supervision Database, have the central bank as supervisory agency for the banking system. Data show that, overall, the level of legal independence of central banks in the selected African economies is low. Nevertheless, among the considered countries, Nigeria, Ghana, and Botswana appear to have the highest score for legal independence of their central banks (0.37, 0.36, and 0.33 respectively). On the other hand, Morocco has the weakest central bank in terms of legal independence, scoring 0.16. In terms of turnover rates, most countries seem to be within the acceptable threshold of 0.2 (e.g., Nigeria, South Africa, Zimbabwe), while Botswana, Ghana, and Egypt are above the limit.

To test whether lower central bank independence in African countries leads to higher levels of capital flight, we use the central bank legal independence index and search for a correlation with capital flight as measured by Ndikumana et al. (2015).[6] Table 4 reveals that capital flight is negatively (although weakly) correlated with central bank independence. In other words, the more legally independent central banks, the less capital flight. Certainly the limited sample on which we ran the analysis does not allow us to draw definite conclusions, but it provides some preliminary hints on a possible role of independent central banks in reducing capital flight from Africa. Figure 5 summarizes the results of the analysis, showing how countries with more independent central banks tend to experience less capital flight, and vice versa.

Morocco, for example, has a central bank with the lowest level of legal independence among the selected countries, and has one of the highest levels of capital flight as percentage of GDP. On the other hand, Ghana, South Africa, and Botswana are characterized by a relatively higher level of independence of their central banks, and have lower shares of capital flight with respect to their GDP.

Weak banking regulation and supervision

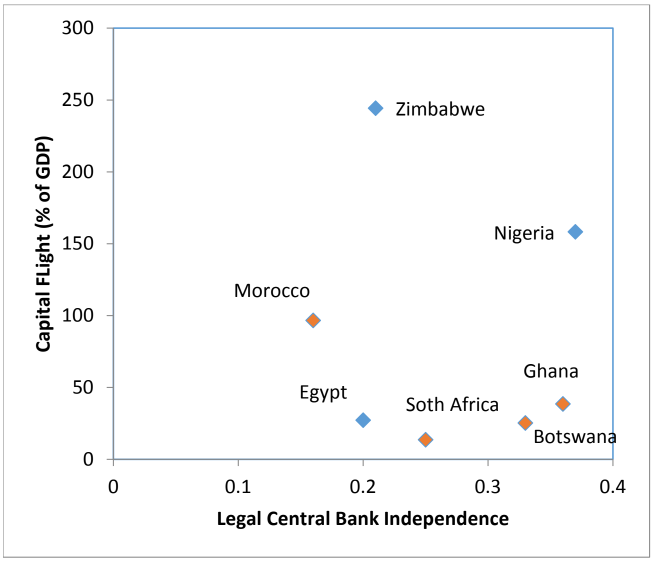
In the literature, it is claimed that concerns about inadequate frameworks for banking regulation and supervision may encourage capital flight. Data related to prudential regulation and supervision of banking systems in sub-Saharan Africa seems to confirm this hypothesis. Indeed, Table 5 sheds light on the fact that countries with well-designed and effectively implemented regulatory and supervisory systems, such as South Africa, Kenya, and Botswana, experience relatively low levels of capital flight as a share of GDP. On the other hand, countries with banking regulatory and supervisory frameworks that are weak, inadequate, or at the early stages of development tend to have much higher levels of capital flight. For

4 Data sourced from the World Bank's Bank Regulation and Supervision Database show that the central bank is the supervisory agency in the following countries: Botswana, Burundi, Egypt, Gambia, Ghana, Guinea, Lesotho, Mauritius, Morocco, Namibia, Nigeria, Rwanda, Seychelles, South Africa, Sudan, Tunisia, and Zimbabwe.

5 See http://emeagwali.com/interviews/capital-flight/africa.html

6 We restrain from using the turnover rates of governors as a measure of central bank independence since low turnover rates do not necessarily imply a high level of independence. Indeed, it could well be the case that a governor remains for long in office precisely because he avoids confrontation or is accommodating with political rulers.

Figure 5. Central bank independence vs. capital flight in selected African countries



Sources: Author's elaboration using Cukierman et al. (1992) and Ndikumana et al. (2015).

example, Cote d'Ivoire and Mozambique, whose banking regulatory system is in its infancy, experience significant capital flight (244% and 215% of GDP, respectively). In a similar way, Madagascar and Zambia, which have put in place just basic structures of a banking regulatory system, are also characterized by high levels of capital flight as a share of GDP (134% and 107%, respectively).

A number of sources of weakness in African banking regulation and supervision may be identified. First, there are loopholes in prudential regulations. For example, although most African countries have currently imposed minimum capital requirements, data from the World Bank's Bank Regulation and Supervision Database show that countries such as Cameroon, Central African Republic, Chad, Congo, and Gabon have capital ratios that are still lower than the 8% threshold required by Basel II. Second, there is a lack of adequately skilled staff to undertake supervision. According to Mehran et al. (1998), with the exception of Mauritius and Tanzania, the average tenure of bank supervisors in SSA countries is between two and five years only. Moreover, according to the World Bank's Bank Regulation and Supervision Database, countries such as Egypt, Ghana, Kenya, Lesotho, Madagascar, and Malawi do not require that auditors have a minimum bank auditing experience. Third, regulatory and supervisory authorities are often subject to political interference and are therefore less efficient and impartial. As mentioned above, in African economies overall, the level of independence of central banks, which are often the supervisory agency for the banking system, is low. Finally,

Table 4. Measures of Central Bank independence in selected African Countries

Country	Legal independence	Actual independence (turnover rates)
Botswana	0.33	0.41
Ghana	0.36	0.28
Nigeria	0.37	0.19
South Africa	0.25	0.10
Zimbabwe	0.21	0.10
Morocco	0.16	0.20
Egypt	0.20	0.31

Source: Author's elaboration on Cukierman et al. (1993).

Table 5. Status of banking regulatory and supervisory systems in selected SSA countries

Group 1		Group 2		Group 3	
Country	Capital Flight (% GDP)	Country	Capital Flight (% GDP)	Country	Capital Flight (% GDP)
Angola	93.90	Ghana	38.40	Botswana	25.20
Burkina Faso	17.50	Madagascar	134.10	Kenya	15.20
Cameroon	89.00	Malawi	27.30	South Africa	13.50
Central African Republic	137.30	Namibia	86.40		
Chad	19.20	Tanzania	64.00		
Congo Rep.	165.50	Uganda	49.00		
Cote d'Ivoire	244.40	Zambia	106.70		
Ethiopia	83.80	Zimbabwe	244.20		
Gabon	192.90				
Guinea-Bissau	195.10				
Lesotho	45.80				
Mozambique	214.70				
Rwanda	165.60				
Swaziland	26.90				
Togo	52.50				

Sources: Author's elaboration using Mehran et al. (1998) and Ndikumana et al. (2015). Notes: Group 1 refers to countries with a banking regulatory and supervisory system at its early stages of development; Group 2 refers to countries with basic structures of a banking regulatory and supervisory system; Group 3 refers to countries with well-designed and effectively implemented banking regulatory and supervisory systems.

the disclosure of financial information is incomplete in several African countries. For example, data reported in the World Bank's Bank Regulation and Supervision database show that in countries such as Ethiopia, Gambia, Sierra Leone, and Uganda, banks are not required to make their annual consolidated financial statements available to the public. Information on off-balance sheet items, governance, risk management frameworks, and the capital adequacy ratio is also not disclosed to the public in several countries.

Banking secrecy

As will be explained in detail in Section 3, banking secrecy, the principle according to which banks are not allowed to reveal the existence of an account or disclose account information about their customers, may encourage the movement of illegal funds, since it prevents national and international authorities from accessing banking information.

In Africa, there are a few economies featured on the global list of the most secretive countries. These are Ghana, Liberia, the Seychelles, and to a lesser extent Botswana and Mauritius (see Figure 8 in Section 3). In order to understand whether the existence of banking secrecy leads to higher levels of capital flight from Africa, we look at the data on capital flight as a share of GDP reported by Ndikumana et al. (2015) in the countries mentioned above. Interestingly, among the African countries characterized by high degrees of banking secrecy, only the Seychelles appears to experience a high level of capital flight as a share of GDP (460%). Ghana and Botswana, instead, have rates of capital flight (38% and 25% of GDP, respectively) that are among the lowest in the list reported by Ndikumana et al. (2015). Although it cannot be interpreted as conclusive evidence, this result seems to suggest that in general, banking secrecy in African countries is not exploited to move legal or illegal domestic funds abroad. Instead, it might be used by residents of other regions to engage in capital flight since these countries are classified as secrecy jurisdictions (see Table A3 in the Appendix).

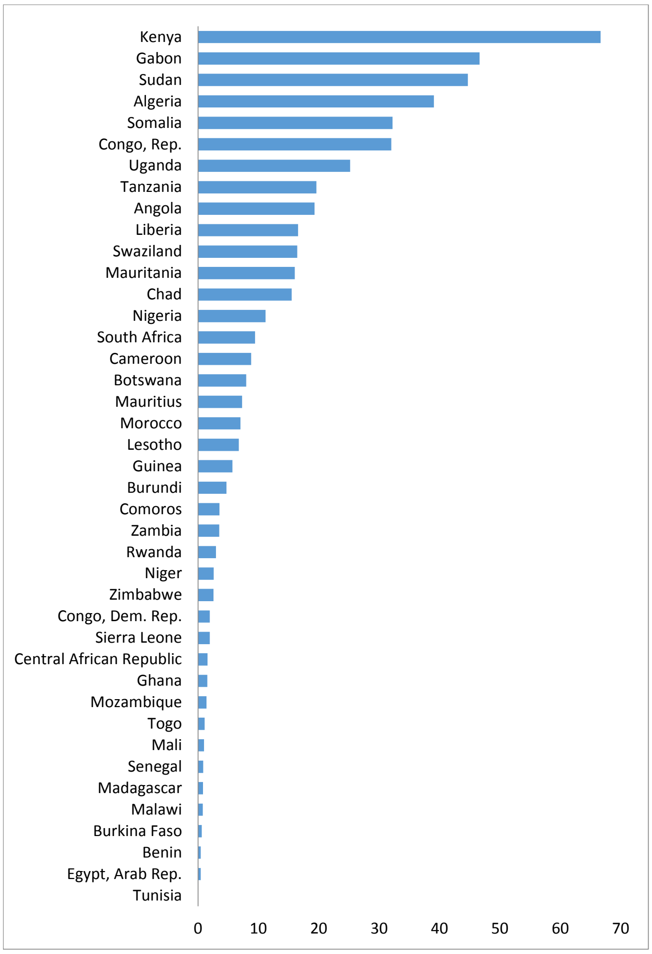
Capital controls

Although the African region has moved toward more open capital accounts over time, in several countries there are still administrative or bureaucratic procedures in place that limit capital outflows. Empirical evidence, for example, shows that in many sub-Saharan Africa countries the use of controls on capital outflows is still widespread (Ndikumana, 2003; IMF, 2008; Murinde, 2009). Note, however, that the prevalence of controls on capital outflows is rather heterogeneous across SSA economies. Countries in the West African Economic and Monetary Union (WAEMU) (Burkina Faso, Cote d'Ivoire, Guinea-Bissau, and Senegal, among others) as well as Angola and South Africa, experience some of the highest levels of prevalence of capital outflow controls, while Uganda, Gambia, and Sao Tome and Principe are among the SSA economies experiencing the lowest levels of prevalence (IMF, 2012).

The existence, absence, or loosening of capital outflow controls may influence the level of capital flight in a given country. Indeed, the presence of capital controls may encourage capital flight through the development of mechanisms for circumventing these regulations, such as over- and under-invoicing, disguising restricted flows as unrestricted flows, and derivative products (Spiegel, 2012). The lack (loosening or ineffectiveness) of capital outflow controls, instead, may either prevent or lead to capital flight. On the one hand, the absence of capital controls may reduce the incentives to shift funds abroad illegally, thus reducing capital flight. On the other hand, if there are no capital controls or if restrictions on capital outflows are eased, it is easier to move funds abroad and the level of capital flight may be higher. This was the case in South Africa, where the loosening of capital controls by the government in the post-apartheid period has offered more opportunities for wealth holders to move capital abroad, thus leading to more capital flight (Epstein, 2005).

Although the evidence on the relationship between capital controls and capital flight in Africa is still limited, a recent econometric study conducted by Ndikumana et al. (2015) on 39 African countries over the period 1970–2010 shows that capital controls may help prevent capital flight.

Figure 6: Mobile money used in selected African countries (% of adult population), 2011



Source: Author's elaboration using data from The World Bank's Global Financial Inclusion Database.
Note: Mobile money represents the percentage of adult population that uses mobile phone to pay bills, receive or send money.

Increasing mobile banking

Mobile banking has taken off in Africa, allowing an increasing number of people to open accounts, pay bills, and transfer money, among other activities. A recent survey of global financial habits by the Gates Foundation, the World Bank, and Gallup World Poll highlights that the use of mobile money in Africa is much higher than that in other regions with even more developed financial systems.[7] Indeed, three-quarters of the countries that use mobile money most frequently are in Africa. The success of mobile banking in the African region relies mainly on three factors: (1) the low costs associated with operating mobile phone accounts; (2) bank coverage, which becomes closely linked to that of mobile phone operators in the territory (Africa is underserviced by land lines, but mobile phone users are growing exponentially in the region); and (3) the ease of operating accounts through mobile phones. Note, however, that the use of mobile banking in Africa is still very heterogeneous across countries. While in economies such as Kenya, Gabon, and Sudan half or more of the adult population use mobile money, there are several other countries that have been left behind by the mobile banking revolution (Central African Republic, Mozambique, Mali, Malawi, Burkina Faso, and Egypt, among many others) (Figure 6).

Mobile banking represents a big step towards social and economic development since it allows access to financial services for millions of people. For instance, in Kenya the establishment of the mobile money transfer service M-PESA in 2007 by Safaricom doubled the number of Kenyans considered financially included. In a similar way,

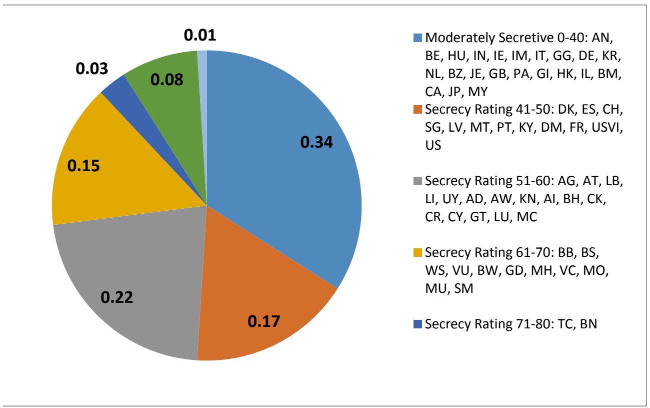
7 See http://www.economist.com/node/21553510

the Mzansi bank account initiative in South Africa, which is based on a magnetic stripe debit card platform, and the WIZZIT mobile phone based banking service, made banking more accessible to unbanked and under-banked communities. According to Ondiege (2010), mobile banking has the potential to halve the number of unbanked people in Africa.

Nevertheless, in principle mobile banking is likely to facilitate capital flight, especially the movement of illegal funds abroad. The reasons are explained in detail in Section 3. Data on mobile money in Africa, however, seem not to confirm this hypothesis since no clear correlation can be identified between capital flight and mobile banking (Figure 7).

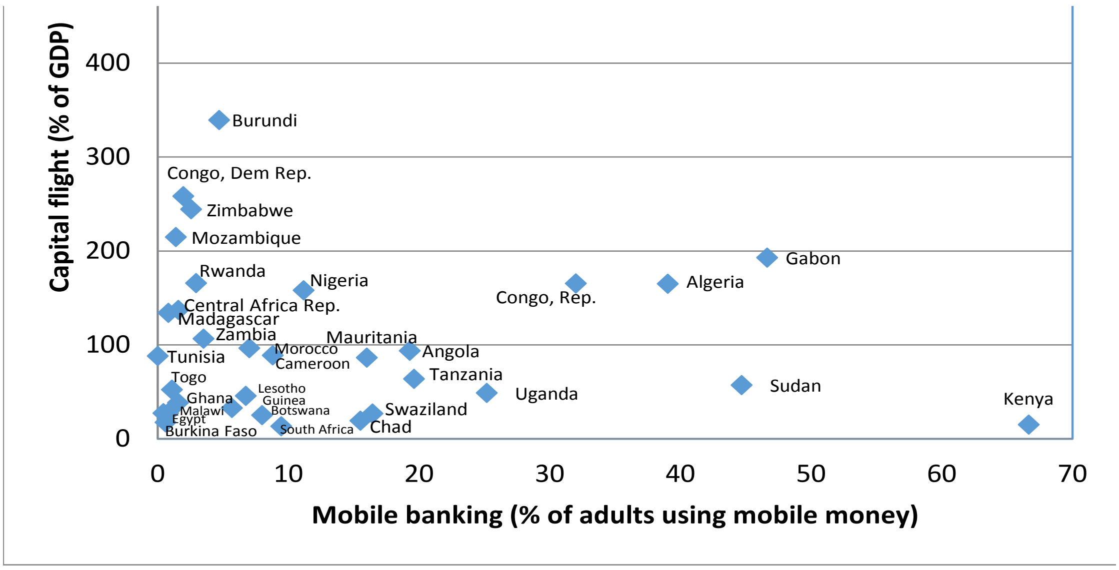
Although this might be due to the fact that mobile banking is a relatively new phenomenon in Africa and therefore it is too early to assess its impact on capital flight, there is also another factor that may explain this result, at least to some extent. There is evidence that so far the mobile banking services have been used by Africans mainly to move just small amounts of money in relation to the payment of bills, the receipt of remittances from family abroad, or simply for small purchases. Therefore, it seems that mobile money has still not been used to transfer large amounts of money abroad. However, it is clear that this type of service has the potential to be used by African people to engage in capital flight activities, especially if it is not well regulated and monitored.

Figure 8. Countries by degree of banking secrecy (% of total)



Source: Tax Justice Network (2011). Note: We refer the reader to Table A1 in the Appendix for an explanation of acronyms.

Figure 7. Mobile banking vs. capital flight in selected African countries



Sources: Author's elaboration using Ndikumana et al. (2015) and the World Bank's Global Financial Inclusion Database.

The global financial system and capital flight

In addition to the features of the domestic financial system discussed in Section 2, there are also a number of characteristics of the global financial system that may facilitate capital flight from Africa. These generally include opportunities made available outside African countries through banking secrecy, business in secrecy jurisdictions, and financial innovation that make it fairly easy and attractive for Africans to transfer and hold legal and/or illegal funds abroad.

Banking secrecy

The culture and practice of banking secrecy is one of the features of the global financial system that contributes the most to encourage the flight of legally or illegally acquired capital from Africa. Banking secrecy refers to what is normally known as banking confidentiality, the principle according to which banks are not allowed to reveal the existence of an account or disclose account information about their customers. Given that banking confidentiality in the destination country ensures that the funds transferred from the source country remain out of the sight of national and international authorities (financial regulators and tax administrators), it enables the flight of illegal capital.

Banking secrecy was first introduced in Switzerland under the Swiss Banking Act in 1934, and since then it has become popular in several countries around the world. However, the degree of banking secrecy is very heterogeneous across countries. The banking secrecy component of the 2011 Financial Secrecy Index (FSI), indeed, reveals that there are countries that are moderately secretive (most of which are Western economies), but also countries such as Maldives which are extremely secretive (Figure 8).

When dealing with banking secrecy, it is important to distinguish between formal secrecy, secrecy based on contract/privacy/common law, and factual secrecy. *Formal banking secrecy* is enforced by legal statutes adopted through legislative processes and/or regulations issued by the executive branch, which provide that banks and their employees should maintain confidentiality, and if such rule of confidentiality is broken specified penalties should apply (see Box 1). Differently from formal banking secrecy, *secrecy based on contract/privacy/common law* finds its origins in the common law—law developed by judges through decisions of courts—and the rule of confidentiality may be broken, although this is often very difficult.

Looking at a sample of 82 developed and developing countries around the world, the OECD (2007) finds that 60 countries—about 73% of the total—are characterized by formal banking secrecy (see Table A2 in the Appendix). Only 22 countries, or 26% of the total, have instead bank secrecy based purely on contract/privacy/common law (Table A2).

Factual banking secrecy refers to not properly checking the identity of an account holder, or of the settlor and beneficiary if the customer is a trust. In other words, it refers to the lack of adequate customer due diligence. According to the "know-your-customer" (KYC) principle, banks should always check the identity of their customers and how they obtained the money when deciding to do business with someone, and they also have to monitor the accounts regularly (BIS, 2001). The KYC principle is important for banks not to incur reputational, operational, legal, and customer concentration risks. It is also key to avoid the hiding and laundering of illegally acquired financial flows. Nevertheless, compliance with the principle is rare across banks. A survey conducted by Global Witness in 2008 on the world's top 50 banks reveals that none of the interviewed banks has developed specific policies to prohibit accounts from politically exposed persons, such as senior government officials and their family members who have access to state funds or take bribes as a result of their position (Global Witness, 2009a). Another survey conducted by Global Witness also sheds light on the fact that compliance officers within banks have limited power to ensure that due diligence is properly done, since they do not sit on the board and their decisions may be easily outweighed by managers willing to go ahead with a dubious business, notwithstanding the existence of a suspicious activity report prepared by compliance officers (Global Witness, 2009a).

While the lack of due diligence may be justified by a bank culture of doing profitable deals regardless of the identity of their customers or the nature of the funds, a number of features and tools of the global banking system also make due diligence difficult, thus facilitating illicit activities (Heggstad and Fjeldstad, 2010; United States Permanent Subcommittee on Investigations, 1999; United Nations Office on Drugs and Crime Prevention, 1998). Some of these are described below:

Examples of penalties applied for breaking bank secrecy

- In Antigua, the Offshore Banking Secrecy Act provides criminal penalties of up to US$ 50,000 or a prison term no longer than one year in the case of un-authorized disclosure of customer's information.
- In the Bahamas, according to the Bank and Trust Company Regulatory Act, a penalty of US$ 15,000 should be imposed on any persons disclosing account information without the Supreme Court order.
- In Austria, the breaking of bank secrecy certified by the Austrian Banking Act is punished with imprisonment of up to one year or a penalty of up to 360 days court rates.
- In Switzerland, the Federal Law on Banks provides a minimum penalty of SFr 50,000 or six months of jail for breaking bank secrecy. If negligence is the cause of the breach in bank secrecy law, the penalty is reduced to SFr 30,000.

- *Numbered accounts*: accounts identified through a random selection of numbers and letters that give complete anonymity to the customer, thus inhibiting the monitoring and tracing of his activity and assets.
- *Coded accounts*: numbered accounts that require not a signature, but only a personal passcode, for the identification of the client, thus giving absolute privacy to the client.
- *Multiple accounts*: accounts opened under multiple names in multiple jurisdictions, which allow the quick movement of funds and make difficult the monitoring and tracing of clients' activity and assets.
- *Offshore accounts*: accounts in the name of offshore entities such as trusts, which allow hiding the identity of both the settlor and the beneficiaries.
- *Offshore recordkeeping*: practice according to which banks keep their clients' records offshore, thus impeding authorities from access to banking data and from monitoring clients' activity.

Episodic evidence shows that secretive accounts offered by major international banks mainly in Western economies have allowed politically exposed persons in several African countries to channel illegally acquired domestic funds outside their countries (Global Witness, 2009a). HSBC and Banco Santander, for example, have shielded behind secrecy laws in Luxemburg and Spain to avoid revealing the ownership of several accounts they held which received suspicious transfers of millions of dollars of Equatorial Guinea's oil money. Moreover, Barclays holds personal accounts of the son of the president of Equatorial Guinea (Teodoro Nguema Obiang), who is suspected of diverting oil funds to his personal accounts abroad. Despite his monthly salary of US$4,000, the son of the president owns a US$35 million mansion in California, as well as a private jet, a fleet of cars, and several luxury properties in France (Global Witness, 2009b). This has recently sparked an investigation in France that ended with the issue of an arrest warrant against him, on the grounds of embezzling state funds, money laundering, and breach of trust. Citibank and Fortis also allowed Charles Taylor, former president of Liberia currently under trial for war crimes, to benefit from the secretive global banking system in order to redirect a significant share of revenues from timber sales in Liberia to his personal accounts and fund his war endeavor. Furthermore, the Bank of East Asia, Hong Kong's third largest bank, is suspected of redirecting the Republic of Congo's oil money into the personal accounts of the son of the president, Denis Christel Sassou Nguesso. Finally, large consortia of banks have helped Angola's state-owned oil company Sonangol to divert cash into private accounts.

Banking secrecy also represents an important obstacle for capital flight repatriation to Africa, which is essential for growth and poverty reduction in the region.[8] Indeed, as long as international banks hide behind bank secrecy laws to help corrupt African leaders move illegally acquired funds out of their countries, it will be impossible for Africa to recover the stolen assets.

Business in secrecy jurisdictions

A secrecy jurisdiction is characterized by the simultaneous existence of three core factors (Tax Research, 2010). First, its regulation is deliberately designed to benefit people who are not resident in its territorial domain. Second, the law of a secrecy jurisdiction is intentionally created to undermine the legislation or regulation of another country. Third, the rule of law of a secrecy jurisdiction prevents the identification of those who use it and are residents outside the geographical domain. Therefore, "[…] secrecy jurisdictions knowingly assist people from outside their domains to break the law in the places where they live and make it as hard as possible for that law breaking to be discovered" (Tax Research, 2010). As such, secrecy jurisdictions facilitate the movement across countries and hiding of illegally acquired funds.

Around the world, 73 secrecy jurisdictions have been identified by the Tax Justice Network through the 2011 Financial Secrecy Index (FSI).[9] Table A3 in the Appendix highlights that secrecy jurisdictions include not only small island developing states (Anguilla, Bahamas, Cook Islands, Grenada, Maldives, and Vanuatu, among others), but also some of the biggest and wealthiest countries in the world

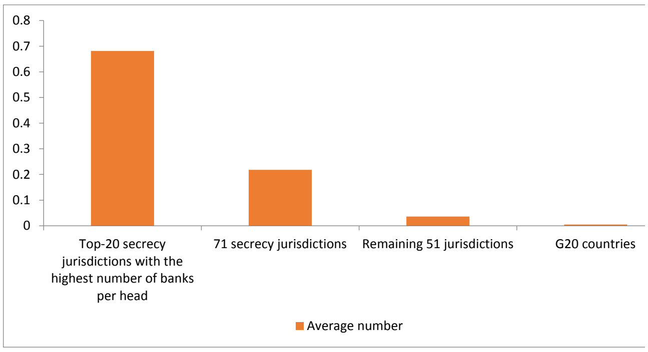
7 Note that in Africa, Mauritius and the Seychelles have formal banking secrecy while South Africa has bank secrecy purely based on contract/privacy/common law.

(Canada, France, Germany, Japan, the United Kingdom and United States, just to mention a few).

A recent study by Harari et al. (2012) shows that banks have increasingly moved their activity in jurisdictions with a high level of financial secrecy (offshore banking) since this allows them to increase their opportunities to make profits. From a quantitative perspective, this is proved by the fact that the average number of banks in the top-20 secrecy jurisdictions per 1,000 inhabitants is about 136 times higher than the average number of banks in G20 countries (Figure 9). Note also that the average number of banks in the top-20 secrecy jurisdictions is significantly higher than that of the remaining 51 jurisdictions, thus suggesting that banks concentrate their business in the most secretive jurisdictions (Figure 9).

By managing international financial flows (some of which are illegal) in secrecy jurisdictions, international banks play an active role in facilitating capital flight from Africa and make it extremely difficult for African countries to trace illegal funds in order to recover stolen assets.

Figure 9. Average number of banks per 1,000 inhabitants in secrecy jurisdictions and G20 countries



Source: Adapted from Harari et al. (2012).

Financial innovation

Financial innovation in the global financial system includes process, product, and institutional innovation. All these types of financial innovation may open new avenues for capital flight as explained below.

Process innovation refers to new ways of doing financial business that are often made possible through improvements in computer and telecommunication technology. Examples of process innovation are the new payment methods (NPM) such as credit or debit cards, prepaid cards, mobile payment services (mobile financial information services, mobile bank account services, mobile payment services, mobile money services), and internet payment services (online banking, prepaid internet payment products, digital currencies).

New payment methods make it easier to engage in illegal capital flight. FATF (2010) identifies a number of characteristics shared by most of the new payment methods that facilitate the hiding and movement of illegal funds:

- Absence of credit risks: several NPM such as prepaid cards, mobile money services, and online payment systems (e.g., PayPal) are prepaid, thus reducing the incentives of the service providers to get adequate information about the customer and the nature of the business relationship.
- Speed of transactions: NPM allow carrying out transactions and withdrawing funds very quickly, thus making the monitoring of funds more difficult.
- Non-face-to-face business relationship: NPM such as prepaid cards, online banking, and mobile banking rely on non-face-to-face business relationships and transactions, thus allowing customers to operate without revealing their true identity.

FATF (2010) also highlights that the risks of capital flight are higher in the case of new payment methods that:

- give the customer absolute anonymity (e.g., prepaid cards) or are implemented in places where customers' identity cannot be verified;
- do not require robust record keeping of transaction data (e.g., internet payment services);
- do not impose a limit on the number of accounts or cards allowed per customer, or do not have a value limit per single payment transaction or per day/week/month/year (e.g., internet payment services or prepaid cards with no or high account caps);
- allow anonymous funding methods such as cash funding (e.g., prepaid cards sold by retailers, or mobile prepaid funds sold by phone shops) or indirect funding through person-to-person transactions;
- have no geographical limits (e.g., prepaid cards designed to function globally, internet payment services);
- have no or minimum usage limits (e.g., Visa and MasterCard branded prepaid cards);
- involve several parties, thus generating potential risks of segmentation and loss of information (e.g., digital

7 See http://www.guardian.co.uk/world/2012/jul/13/france-arrest-warrant-equatorial-guinea

8 See Fofack and Ndikumana (2009) for an estimation of the magnitude of potential benefits from capital repatriation to sub-Saharan Africa.

9 The FSI is constructed by combining qualitative and quantitative data, and ranks secrecy jurisdictions according to their degree of secrecy and the scale of their trade in international financial services.

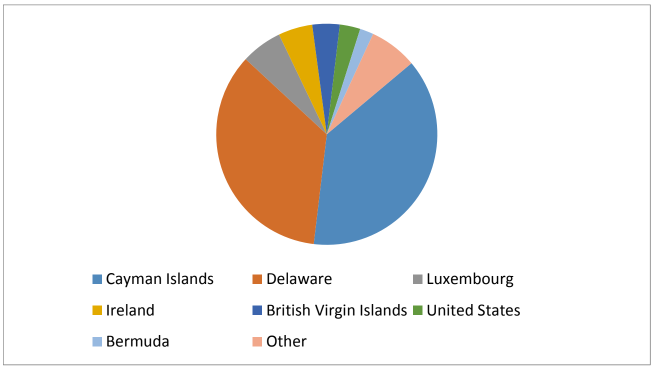
currency providers using exchangers as an integral part of the payment transaction chain).

Product and institutional innovation refers to the creation of new financial products and new types of financial firms, respectively. Among these, unregulated financial instruments (e.g., financial derivatives) and unregulated intermediaries (e.g., hedge funds and private equity funds), which constitute the so-called shadow banking system, have played and continue to play an active role in facilitating illegal financial transactions across countries.

Financial derivatives are financial instruments whose value derives from the price of one or more underlying assets (e.g., equities, debt, currencies, or indexes of assets), and which are used to trade specific financial risks in financial markets. Empirical evidence shows that financial derivatives have been often used to hide and launder illicit funds. The United States Permanent Subcommittee on Investigations (2006, 2008), for example, reports that stock options and total return swaps have been used in abusive transactions to defer and avoid U.S. taxes.

On the other hand, new institutional investors such as hedge funds and private equity funds may act as a conduit for the transfer of illegal financial flows by making use of off-shore financing instruments and secrecy jurisdictions. Eurodad et al. (2008) report that nearly all hedge funds and private equity funds are registered in secrecy jurisdictions. For example, recent data shows that the Cayman Islands (one of the most secretive jurisdictions) host the biggest share of the world's total number of hedge funds (Figure 10). Moreover, regardless of the registration, almost all hedge funds and private equity funds make use of investment vehicles registered in tax havens.

Figure 10. Location of hedge funds by domicile (% of total), January 2013



Source: Adapted from The Economist (2013). Note: The total number of hedge funds is 6,999.

Although to our knowledge there is little empirical or episodic evidence on the extent to which African people have used the above financial innovations offered by the global financial system to move legally or illegally acquired funds outside their countries, it is likely that this will occur in the future since these innovative financial processes, products, and institutions offer new profit opportunities and make it easy to conceal illegal funds if not properly regulated.

Policy responses

A number of policies have been introduced at both the national and international level to prevent capital flight from African countries and enable the repatriation of stolen assets. At the national level, most of the initiatives aim at fighting corruption as a key source of illegal funds that are transferred or held abroad. At the international level, a number of initiatives aim to prevent and combat capital flight by specifically strengthening the global financial system. Nevertheless, as explained below, the effectiveness of these measures is still limited due to a number of weaknesses at both the local and global level.

African responses

Capital flight is a matter of major concern for Africa, given its negative impacts on growth and development. Therefore, local governments have tried to put forward a series of initiatives and conventions to fight this phenomenon, particularly illegal capital flight. Some of these efforts include the Southern African Development Community (SADC) Protocol against Corruption, the African Union Convention on Preventing and Combating Corruption, the High Level Panel on illicit financial flows, and the African Regional Anti-Corruption Programme.

SADC's Protocol against Corruption, adopted in 2001, was the first sub-regional anti-corruption treaty in Africa. The protocol provides a set of preventive and enforcement mechanisms to fight corruption and thereby reduce illegal financial transactions abroad. Among the preventive measures, the development of a code of conduct for public officials, transparency in the public procurement of goods and services, easy access to public information, the development of systems of accountability and controls, the criminalization of bribery, the confiscation of the proceeds of crime, and sensitization through the media, civil society, and public education are all mentioned. A committee, whose responsibilities ranged from disseminating information on corruption and organizing training programs to providing technical assistance, was established for ensuring the effective implementation of the above measures.

The African Union Convention on Preventing and Combating Corruption aims at strengthening the capacity of African states to prevent, detect, punish, and eradicate corruption in the public and private sector by promoting adequate mechanisms for facilitating cooperation between State Parties, harmonizing their policies and legislation, and fostering transparency and accountability in the management of public affairs.

The High Level Panel on illicit financial flows, chaired by President Thabo Mbeki, was established in 2011 to secure a strong African voice at the international level in the fight against illicit financial flows.

Finally, the African Regional Anti-corruption Programme (2011–2016), which was developed jointly by the United Nations Economic Commission for Africa (UNECA) and the African Union Advisory Board on Corruption (AUABC) to fight illicit financial flows, is particularly important because it puts strong emphasis on stolen asset recovery.

International responses

On their own, national efforts are insufficient to deal with the problem of capital flight because of its wide geographical spread. Therefore, a number of international bodies have either created global standards or developed conventions and treaties to help the global financial system respond adequately to threats such as the movement and hiding of illegal funds due to corruption, money laundering, tax evasion, and organized crimes. Among these, the Financial Action Task Force (FATF), the Bank for International Settlements (BIS), the United Nations, the Organization for Economic Cooperation and Development (OECD), the Council of Europe, and the G20 are worth mentioning. In addition, private sector associations such as the Wolfsberg Group are notable.

The Financial Action Task Force is an inter-governmental organization, established in 1989, whose members include 34 countries and two regional organizations, namely, the European Commission and the Gulf Co-operation Council. Only South Africa is a member of the FATF, while a number of other African countries may take part in the FATF because they are members of regional bodies such as the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG), Inter-Governmental Action Group against Money Laundering in West Africa (GIABA), and the Middle East and North Africa Financial Action Task Force (MENAFATF), which are all recognized as FATF Associate Members. As part of the FATF Associate Members, African countries endorse the FATF Recommendations, promote the effective implementation of the FATF standards in their jurisdictions, and participate in the development of the FATF standards.

The FATF has created a series of Recommendations that establish a comprehensive framework of preventive measures that financial institutions should implement to combat illegal financial flows. These measures, which should be set out in law, include (FATF, 2012):

- *customer due diligence*—identification of the customer, verification of the customer's identity, identification of the beneficial owner, and assessment of the purpose and nature of the business relationship to be conducted using reliable and independent source documents, data, or information;
- *record keeping*—keeping all records on transactions for at least five years;
- *enhanced due diligence for specific customers and activities*—mechanisms such as appropriate risk-management systems, request of approval by senior management, enhanced monitoring, and gathering of additional information (for example, on the source of funds), with respect to specific customers, such as politically exposed persons, as well as specific activities, such as correspondent banking, money or value transfer services, new technologies, and wire transfers;
- *adequate systems of control*—reliance on third parties or financial groups to strengthen control;
- reporting of suspicious transactions to the financial intelligence unit.

The FATF has also developed a system of peer reviews, or a mutual evaluation program, which allows it to assess the level of implementation of FATF Recommendations by its members. In the past, only *compliance* with the Recommendations was evaluated. Currently, however, more emphasis is placed on assessing the *effectiveness* of the measures put in place to implement them.

The Bank for International Settlements, which counts among its members just two African countries (Algeria and South Africa), has also established a set of know-your-customer standards in line with FATF's Recommendations. These standards, too, prevent banks from being used for illicit purposes. Moreover, the BIS has developed a list of what financial institutions should regard as suspicious activity (BIS, 2001):

- transactions without an obvious economic or commercial sense;
- transactions involving large cash deposit amounts which are not consistent with the normal and expected transactions;
- very high account turnover inconsistent with the size of the balance.

The United Nations, in turn, have developed a number of conventions. Among these, it is worth mentioning the United Nations Convention against Corruption (UNCAC), which came into force in 2005 and has been signed and ratified by many countries, included the majority of African countries. In order to prevent and combat illegal capital flight, the Convention deems it necessary to create a comprehensive domestic regulatory and supervisory regime for banks and non-bank financial institutions; facilitate cooperation and exchange information at the national and international levels among administrative, regulatory, law enforcement, and other bodies dedicated to fighting the movement and hiding of illegal capital; establish a financial intelligence unit for the collection, analysis, and dissemination of information on money laundering; and to require financial institutions to gather information on the source of funds. The UNCAC also aims to promote effective legal mechanisms for asset recovery.[10]

In 1988, the Council of Europe and the OECD developed the Convention on Mutual Administrative Assistance in Tax Matters, which was opened for signature only to member states of both organizations. It was not until April 2009 that the Convention was reviewed and opened for signature to all countries. Nevertheless, only 4 African countries have signed the Convention: Ghana, Morocco, South Africa, and Tunisia. The Convention includes all possible forms of administrative cooperation between signatory countries in the assessment and collection of taxes, with a particular view to combat tax avoidance and evasion. This co-operation ranges from the exchange of information, including automatic exchanges, to the recovery of foreign tax claims.

The G20 has also joined the fight against illegal funds channelled through the global financial system. Indeed, after the 2007–08 global economic and financial turmoil, at the April 2009 Summit, the G20 leaders committed to coordinating efforts to end bank secrecy in order to limit illicit capital flight and improve tax collection. To this end, they required offshore centers to sign bilateral treaties according to which they must release information on accounts that may be used to evade taxes or bear the burden of economic sanctions. This has been by far the largest coordinated action against tax evasion to date, and as a result the world's offshore centers signed more than 300 bilateral treaties (Johannesen and Zucman, 2012). Among African countries, only Morocco, Tunisia, Mauritania, Senegal, Liberia, Burkina Faso, Ghana, Nigeria, Cameroon, Gabon, Kenya, Uganda, Botswana, South Africa, and Lesotho have taken advantage of these bilateral treaties providing for the exchange of information.[11]

Finally, turning to private sector associations, the Wolfsberg Group was created in 2000 by eleven global banks with the objective of creating a set of global standards that may guide the banking industry in shaping its due diligence, anti-money laundering, and

10 A detailed description of the UNCAC's measures and implementation mechanisms to combat illegal capital flight is beyond the scope of this paper. See the text of the convention at: http://www.unodc.org/documents/treaties/UNCAC/Publications/Convention/08-50026_E.pdf

11 More details on the bilateral treaties signed by African countries can be found on the Exchange of Tax Information Portal, available at: http://eoi-tax.org/

counter-terrorist financing policies. The Wolfsberg Group has produced a number of documents that include, but are not limited to, the Wolfsberg Anti-Money Laundering Principles for Private Banking, first published in 2000 and revised for the last time in 2012. These Principles are a voluntary code of conduct that focuses on private banking, and builds on the well-established concepts of customer identification and increased due diligence in unusual cases. Unlike other standards, the Wolfsberg Principles promote a risk-based due diligence rather than a rule-based one (Pieth and Aiolfi, 2003)In addition to the Anti-Money Laundering Principles for Private Banking, the Wolfsberg Group has recently published the Guidance on Prepaid and Stored Value Cards, which deals with the money laundering risks associated with new payment methods.

Effectiveness of policy responses: what are the challenges?

Section 4.2 discussed the plethora of polices, conventions, and other tools that have been deployed to fight illegal financial flows, particularly from Africa. While these initiatives are positive developments, there is evidence that their effectiveness is far from satisfactory.

To mention a few examples, recent assessments conducted by the Eastern and Southern Africa Anti-Money Laundering Group reveal that the degree of compliance with FATF Recommendations is still extremely low in several African countries. Specifically, in Mozambique, Namibia, Swaziland, Uganda, and Tanzania, compliance with FATF's preventive measures for banks is extremely weak (Table 6).

Moreover, there seems to be few successful cases of asset recovery in Africa.[12] One is the case of Nigeria, where the government, through an effective asset recovery strategy, was able to track down and recover US$2.3 billion stolen by its former dictator, Sani Abacha (Maton and Daniel, 2012).

A recent econometric study, on the effectiveness of the bilateral treaties that the G20 required offshore centers to sign, also reveals that their impact on bank deposits in tax havens has been modest (Johannesen and Zucman, 2012). Most tax evaders did not respond to the treaties, while a minority responded by transferring their deposits to havens not covered by a treaty. The mere relocation of bank deposits between tax havens leaves the total amount of funds managed offshore essentially unchanged. Shaxson and Christensen (2011) also find that the treaties led to negligible benefits and left considerable scope for bank secrecy.

What factors constrain the effectiveness of national and international policy responses to capital flight from Africa? First, there is a lack of political will. In Africa, corrupt government officials tend to protect their own interests by remaining passive rather than pro-active in promoting the necessary mechanisms to combat capital flight and promote asset recovery. In some cases, they obstruct such initiatives through pervasive political interference. Moreover, there is no strong political determination in destination countries to uncover illegal funds because of the strategic interests of governments or financial institutions.

Second, international initiatives present a number of weaknesses. Several have not been ratified by many African countries, which therefore have no incentive to cooperate with their mandates. In addition, in most cases, only a few African countries have been actively involved in the development of such initiatives, which therefore do not take into account specific African characteristics when developing preventive and implementation mechanisms. Moshi (2007) points out that the FATF Recommendations do not sufficiently recognize that African economies are largely cash-based, heavily reliant on the informal banking system, and make extensive use of informal value transfer methods. A welcome step to correct this lack of African voice in global fora is the High Level Panel on Illicit Financial Flows mentioned in Section 4.1, but there is still much to be done. Another shortcoming is that most of the developed international standards are guidelines that lack a specific legal enforcement mechanism, and therefore may be rather easily watered down at the national level. It is also worth highlighting that the credibility of some international initiatives tends to be rather weak. This may be due to the fact that their funders are often not compliant, or at least not fully, with the same recommendations that they provide to other countries in Africa or other parts of the world. For example, in the case of the Wolfsberg Group, member banks such as Banco Santander, Citibank, or Barclays are well known for having facilitated the movement and hiding of funds acquired illegally by African corrupt government officials. In a similar way, the economic sanctions provided by the G20 to banks which do not release information on accounts used to evade taxes may not be a credible deterrent, since historically bankers have always remained unpunished even when stolen assets have been discovered in their countries.

Third, the existence of regulatory loopholes and weak governance in Africa, as well as the lack or low level of expertise and knowledge significantly constrain the effective implementation of national and international initiatives aimed at stopping capital flight and promoting repatriation of stolen assets. In the case of asset recovery processes, the fact that the requesting African country is perceived by the requested country as corrupt or lacking good governance

11 The eleven global banks include Banco Santander, Bank of Tokyo-Mitsubishi UFJ, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, J.P. Morgan Chase, Société Générale, and UBS.

12 Ayogu and Agbor (2014) discuss a number of ongoing cases of asset recovery legal procedures involving former rulers in Nigeria and Equatorial Guinea.

may be used as a basis for refusing repatriation, even when the illegal funds have been uncovered.

Fourth, the lack of collaboration between local and foreign authorities limits severely the effectiveness of investigations and the repatriation of illegal financial flows. The problem of capital flight from Africa always involves a source African country and one or more destination foreign economies. Therefore, a concerted effort by both source and destination countries is essential to deal effectively with the problem. That local authorities and financial intelligence bodies in foreign destination countries cooperate in exchanging financial information, even if this requires overriding bank secrecy, is paramount.

Fifth, differences in the legal systems of source African economies and foreign destination countries represent a major obstacle for uncovering and repatriating illegal funds. For example, dual criminality—the fact that an activity from which a given asset is derived (predicate crime) is recognized as illegal in one country, but not in the other—is a severe constraint to the effectiveness of asset recovery procedures, which instead requires the harmonization between the legislations of the countries involved.

Finally, the lack of a universally recognized institutional body, which could serve as a platform for policy debate and implementation, is a significant barrier to the development of a global solution to combat the movement and hiding of legal and illegal funds.

Table 6. Selected African countries: compliance with FATF's preventive measures for banks

	Customer due diligence and record keeping		Additional measures for specific customers and activities					Reliance, Controls and Financial Groups			Reporting of suspicious transactions		Designated Non-Financial Business and Professions (DNFBPs)	
						New	Wire		Internal controls and foreign			Tipping-off and		Other
Angola	PC	LC	PC	C	PC	LC	PC	N/A	PC	PC	PC	C	NC	PC
	NC	LC	NC	NC	NC	PC	NC	PC	PC	NC	NC	LC	NC	PC
Comoros	NC	NC	NC	LC	NC	PC	NC	NC	NC	NC	NC	LC	NC	PC
Kenya	NC	PC	NC	NC	NC	NC	NC	NC	NC	NC	NC	PC	NC	LC
Lesotho	NC	NC	PC	C	NC	NC	NC	PC	NC	NC	NC	PC	NC	PC
Malawi	PC	LC	PC	LC	NC	NC	LC	PC	PC	PC	PC	LC	NC	LC
Mauritius	PC	LC	PC	PC	NC	PC	PC	LC	PC	PC	PC	C	NC	C
	NC	NC	NC	NC	NC	NC	NC	NC	NC	NC	NC	NC	NC	LC
Namibia	NC	NC	NC	NC	NC	NC	NC	NC	NC	NC	NC	PC	NC	LC
	NC	PC	PC	PC	NC	NC	PC	NC	NC	NC	PC	C	NC	PC
South Africa	PC	PC	NC	NC	PC	PC	PC	NC	PC	NC	LC	C	PC	C
	NC	NC	NC	NC	NC	NC	NC	NC	NC	NC	NC	NC	NC	NC
Tanzania	NC	NC	NC	NC	NC	NC	NC	NC	NC	NC	NC	PC	NC	C
Uganda	PC	PC	NC	NC	PC	NC	NC	NC	PC	NC	NC	NC	PC	PC
Zambia	NC	PC	NC	NC	NC	NC	NC	NC	NC	NC	NC	PC	NC	NC
	PC	C	C	PC	PC	PC	NC	C	LC	PC	PC	PC	NC	PC

Source: Author's elaboration on different ESAAMLG Mutual Evaluations downloaded at: http://www.esaamlg.org/reports/me.php Notes: C=Compliant, PC=Partially compliant, NC=Not Compliant, LC=Largely Compliant, N/A=not available information.

Conclusions and policy recommendations

Capital flight is among the major challenges facing the developing world, and Africa in particular, because it represents a severe constraint for growth and development. This paper has argued that the financial sector should not be regarded as a passive player when analyzing legal and illegal capital flight from Africa. Indeed, a number of features of both the domestic and global financial systems may be conducive to injurious capital flight from Africa and impede asset recovery.

Looking at the domestic side, this paper has provided some illustration of how factors such as a high presence of foreign banks; the existence of underdeveloped stock, bonds, and to some extent, derivative markets; the lack of credible deposit insurance protection schemes; the scant independence of supervisory agencies; the presence of weak banking regulatory frameworks; the use of capital controls; and the take-off of mobile banking may lead to high levels of capital flight from Africa. At the global level, banking secrecy, business in secrecy jurisdictions and financial innovation may make it fairly easy for Africans to transfer and hold legal and illegal funds abroad. Banking secrecy and financial activities in secrecy jurisdictions also represent an important barrier for capital repatriation to Africa.

A plethora of policy responses have been developed at both the national and international level to prevent capital flight from Africa and facilitate stolen assets repatriation. At the national level, most of the initiatives aim at fighting corruption as a key source of illegal funds that are transferred or held abroad through the financial system. At the international level, many initiatives aim to prevent and combat capital flight by specifically strengthening the global financial system. Nevertheless, this paper has underscored that the effectiveness of these measures is far from satisfactory, due to a number of factors, which include but are not limited to: (1) the lack of political will at both the African and global level; (2) weaknesses of the initiatives promoted at the international level, such as the lack of legal enforcement mechanisms, weak credibility, and the limited involvement of African countries; (3) the existence in Africa of regulatory loopholes, weak governance, and low levels of expertise and knowledge; (4) the lack of collaboration between local and foreign authorities; (5) differences in the legal systems of African economies and foreign countries; and (6) the lack of a universally recognized institutional body for global governance.

What can be done? By enhancing the soundness of the domestic banking system, developing local financial markets, and offering adequate protection to depositors, African governments may reduce the incentives for Africans to exploit better investment opportunities abroad and thereby engage in capital flight. It is also essential that governments properly monitor and regulate new financial processes and products such as mobile banking and credit derivatives. Only in this way will African countries be able to benefit from financial innovation (enhanced financial inclusion in the case of mobile banking) without losing, through capital flight, resources that are vital to fostering economic growth and development.

The improvement of domestic financial supervision, governance, and human capacity should also be a policy focus area for African countries to fight illegal capital flight and facilitate asset recovery. Having independent supervisory agencies, adequately skilled staff to undertake supervision, and a high level of governance is essential to stop corrupt government officials from moving illegally acquired funds abroad as well as to provide the right incentives for destination economies not to refuse capital repatriation when illegal funds are uncovered. Clearly, strong political will of African governments is critical for reaching these objectives and making African voices heard at the international level. The battle against the corruption of African public officials should be continued and strengthened.

The international community, in turn, needs to promote transparency in the global financial system through the development and implementation, by means of legal enforcement instruments, of adequate and credible mechanisms. These should aim at ensuring that financial intermediaries in destination economies receiving financial flows from Africa implement appropriate customer due diligence practices to identify the identity of their customers as well as the source of transferred funds. These mechanisms should also ensure that financial intermediaries cooperate with African and international supervisory authorities by providing relevant financial information without hiding behind bank secrecy laws in order to protect their profit interests. Fofack and Ndikumana (2009) suggest that a possible mechanism for achieving the latter objective may be to include information on the transparency of banking practices in the rating of international banks.

Another international policy focus should be the harmonization of countries' legislations with respect to capital flight and asset recovery. This will require a coordinated and concerted effort of several national and international stakeholders including governments, lawyers, accountants, and many others. If a harmonized international legal framework is developed, only then will the hurdles that often complicate the investigations of illegal capital flows and the return of assets (e.g., dual criminality) be overcome.

Finally, there is a need for the international community to create a universally recognized inter-governmental body that could serve as a platform for policy debate, and with a clear mandate from all member countries to supervise the functioning of the international financial system and collect all the necessary information on capital flight. The mandate should be ratified and included in the constitution of all member countries, with clearly defined responsibilities and enough independence to act whenever and wherever necessary. This is certainly a difficult objective to achieve, especially at the global level, but Africa could lead the way by creating a regional organization (or using an existing one) with a mandate to regulate and supervise African financial transactions across countries.

For future research, it may be relevant to extend the findings of this paper to an econometric study that uses some key aspects of the national and international financial system as explanatory variables. These have been shown to have a non-negligible effect on capital flight from Africa, and a quantitative study may contribute evidence-based policy suggestions. The variables include the share of foreign banks in African countries, the degree of development of African stock and bond markets, the level of independence of African central banks, the degree of banking secrecy in African and foreign economies, and the penetration of mobile banking, among others.

It may also be important to conduct a number of African country case studies to assess the effectiveness of some of the key, existing national and international policies that aim to combat capital flight and facilitate asset repatriation. More evidence at the country level would be useful to local and foreign governments moving forward in the development of more effective policy responses.

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Appendices

Table A1. Countries' acronyms

Country	ISO
Andorra	AD
Anguilla	AI
Antigua & Bermuda	AG
Aruba	AW
Austria	AT
Bahamas	BS
Bahrain	BH
Barbados	BB
Belgium	BE
Belize	BZ
Bermuda	BM
Botswana	BW
British Virgin Islands	VG
Brunei	BN
Canada	CA
Cayman Islands	KY
Cook Islands	CK
Costa Rica	CR
Cyprus	CY
Denmark	DK
Dominica	DM
France	FR
Germany	DE
Ghana	GH
Gibraltar	GI
Grenada	GD
Guatemala	GT
Guernsey	GG
Hong Kong	HK
Hungary	HU
India	IN
Ireland	IE
Isle of Man	IM
Israel	IL
Italy	IT
Japan	JP
Jersey	JE
Korea	KR
Latvia	LV

Table A1. Countries' acronyms (continued)

Country	ISO
Japan	JP
Jersey	JE
Korea	KR
Latvia	LV
Lebanon	LB
Liberia	LR
Liechtenstein	LI
Luxembourg	LU
Macau	MO
Malaysia (Labuan)	MY
Maldives	MV
Malta	MT
Marshall Islands	MH
Mauritius	MU
Monaco	MC
Montserrat	MS
Nauru	NR
Netherlands	NL
Netherlands Antilles	AN
Panama	PA
Philippines	PH
Portugal (Madeira)	PT
Samoa	WS
San Marino	SM
Seychelles	SC
Singapore	SG
Spain	ES
St Kitts and Nevis	KN
St Lucia	LC
St Vincent & Grenadines	VC
Switzerland	CH
Turks & Caicos Islands	TC
United Arab Emirates (Dubai)	AE
United Kingdom	GB
Uruguay	UY
US Virgin Islands	USV
USA	US
Vanuatu	VU

Source: Tax Justice Network (2011).

Table A2. List of countries with formal banking secrecy and with secrecy based on contract/privacy/common law

Bank Secrecy based on contract/privacy/ common law	Formal Bank Secrecy
Antigua and Barbuda	Andorra
Australia	Anguilla
Belgium	Aruba
Bermuda	Argentina
British Virgin Islands	Austria
Canada	The Bahamas
Germany	Bahrain
Gibraltar	Barbados
Guemsey	Belize
Hong Kong, China	Brunei
Hungary	Cayman Islands
Ireland	China
Isle of Man	Cook Islands
Italy	Costa Rica
Japan	Cyprus
Jersey	Czech Republic
Netherlands	Denmark
Netherlands Antilles	Dominica
New Zealand	Finland
South Africa	France
United Arab Emirates	Greece
United Kingdom	Grenada
	Guatemala
	Iceland
	Korea
	Liechtenstein
	Luxembourg
	Macao, China
	Malaysia
	Malta
	Marshall Islands
	Montserrat
	Mauritius
	Mexico
	Monaco
	Nauru
	Niue
	Norway
	Panama

Table A2. List of countries with formal banking secrecy and with secrecy based on contract/privacy/common law (continued)

Bank Secrecy based on contract/privacy/ common law	Formal Bank Secrecy
	Philippines
	Poland
	Portugal
	Russian Federation
	Saint Kitts and Nevis
	Saint Lucia
	Saint Vincent and the Grenadines
	Samoa
	San Marino
	Seychelles
	Singapore
	Slovak Republic
	Spain
	Sweden
	Switzerland
	Turkey
	Turks and Caicos Islands
	United States
	United States Virgin Islands
	Uruguay
	Vanuatu

Source: OECD (2007).

Table A3. Secrecy jurisdictions according to the 2011 Financial Secrecy Index (FSI)

Andorra	Grenada	Montserrat
Anguilla	Guatemala	Nauru
Antigua & Barbuda	Guernsey	Netherlands
Aruba	Hong Kong	Netherlands Antilles
Austria	Hungary	Panama
Bahamas	India	Philippines
Bahrain	Ireland	Portugal
Barbados	Isle of Man	Samoa
Belgium	Israel	San Marino
Belize	Italy	Seychelles
Bermuda	Japan	Singapore
Botswana	Jersey	Spain
British Virgin Islands	Korea	St Kitts & Nevis
Brunei Darussalam	Latvia	St Lucia
Canada	Lebanon	St Vincent & Grenadines
Cayman Islands	Liberia	Switzerland
Cook Islands	Liechtenstein	Turks & Caicos Islands
Costa Rica	Luxemburg	United Arab Emirates
Cyprus	Macau	United Kingdom
Denmark	Malaysia	Uruguay
Dominica	Maldives	US Virgin Islands
France	Malta	United States
Germany	Marshall Islands	Vanuatu
Ghana	Mauritius	
Gibraltar	Monaco	

Source: http://www.financialsecrecyindex.com/index.html#table1

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