



SELF REGULATION

In the Private Financial Sector As a Major Factor in

COUNTERING CORROSIVE CAPITAL FLOWS

Corrosive Capital and Investments Screening

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A person is sitting in a chair, seen from behind, with their hands resting on their head. They are looking at a large screen that displays a world map and the word "WORLD". The background is a light gray with a diagonal split. The top-left portion is white, and the bottom-right portion is a faded image of the person and the screen.

THE MODERN FINANCIAL INFRASTRUCTURE

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CAPITAL FLOWS THROUGH REGULATED PRIVATE CHANNELS

- Corrosive capital needs legitimate channels to move through. Otherwise it becomes criminal and fails in its primary mission.
- The legitimate channels for moving serious money across borders are concentrated in two highly regulated private industries – commercial banks and investment banks (investment intermediaries and regulated investment vehicles included).
- The private financial sector is VERY receptive to political messaging and the threat / hint of government intervention.
- Banks (both the investment and commercial kind) are very protective of their reputation – they cease operations without it almost immediately.
- Corrosive capital principals face increasing difficulties in identifying willing private financial sector actors to move money through.
- Unlike government agencies, strictly regulated private-sector actors are harder to corrupt and co-opt in schemes designed to conduct corrosive capital – apart from potential criminal liability, they risk losing everything.

NO ROAD, NO DESTINATION, NO ACHIEVEMENT OF OBJECTIVES

- Choking the legitimate private financial sector channels is KEY in stopping corrosive capital flows.
- This is much EASIER, FASTER, CHEAPER and MORE EFFICIENT than creating and enforcing legislative measures.
- NO SPECIAL LEGISLATIVE MEASURES ARE NECESSARY.
- NO ADDITIONAL GOVERNMENT RESOURCES ARE NECESSARY.
- Blocking the ability of bad actors to use the private financial sector in democratic countries is primarily a matter of working closely with the private financial sector actors.
- The government should simply create a high sensitivity to risk in the private sector: if any bank is implicated in conducting corrosive capital, this is the beginning of the end for it as a going concern. Its shareholders lose everything, its managers will be branded for life.
- Without the means to conduct investments (without facilitators in the private financial sector), no corrosive capital principals will be able to stain the economy and undermine the targeted society.

GOVERNMENT REGULATION OF FINANCIAL SECTOR ACTORS

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THE CONCEPT OF RISK

- The basic justification and main objective of government regulation of the private financial sector is RISK MITIGATION.
- RISK is a concept which comes in many forms – credit/counterparty risk, systemic risk, operational risk. Over the past 20 years, AML/CTF functions were increasingly added to the risk management domain.
- However, a new and important kind of risk emerged lately as a major driver in the behaviour of financial institutions. This is REPUTATIONAL RISK.
- REPUTATIONAL RISK is the risk of a financial institution failing (or degrading its financial stability significantly) due to the leak of damaging information in the public domain. It is not explicitly regulated.
- Regulators are starting to pay attention to this risk category and are gradually citing broader oversight powers to manage financial stability as a reason to issue recommendations to financial institutions regarding mitigating reputational risks.



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THE PRIMARY OBJECTIVE IS TO STAY IN BUSINESS

- All commercial entities – and especially highly regulated financial institutions with a higher public profile than most other companies – want to survive and continue operations for the benefit of their owners.
- If any action (or transaction) jeopardizes that objective in any way, it will be vetoed by the management, although it may be perfectly legal and have a high potential economic benefit.
- Corrosive capital flows are usually part of legally compliant transactions with high economic benefits for the financial institutions.
- However, once the primary objective of the institution is under threat, economic benefit or legal compliance will not be enough to make the management or owners of the financial institution go through with the deal.
- Therefore, THE GOVERNMENT'S OBJECTIVE SHOULD BE TO PUT THE SURVIVAL OF THE FINANCIAL INSTITUTION UNDER THREAT IN CASE IT PROVIDES SERVICES TO CERTAIN UNDESIREBLE ACTORS. That easily trumps everything else.

SELF REGULATION AND SELF RESTRAINT

- Financial institutions are VERY SENSITIVE to political messaging. No one wants to be front-page news with pictures of regulatory auditors and law enforcement agents taking out boxes of documents through the front door. That is why financial institutions will strictly enforce – as a matter of corporate policy, not of regulatory requirements – any “black list”, or “designation list” by a government agency.
- Although fiercely competitive, financial institutions are also a highly cooperative gang. They protect each others’ back because of a phenomenon called “contagion”. It is a sinister domino effect, where one busted institution may quickly drag the whole industry down with it. And no one knows who’s next. That is why they create and share industry “black lists”. And this does not only include clients who fail to make the installments on their loans either. These are potential clients who have a very high “reputational risk” profile.
- Creating and carefully curating such “designation lists” should be a major focus of any modern intelligence agency. It certainly beats creating new government bureaucracies, like commissions and committees for screening foreign investments.



CONCLUSION (TO-DO LIST FOR GOVERNMENTS)

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THE CORROSIVE CAPITAL STOP LIST FOR GOVERNMENTS

- Create an interface with the private financial sector. There should be a unit dealing with corrosive capital flows in the intelligence community, usually related to the AML/CFT task force.
- Work with the (independent) financial regulators. They should start creating and enforcing “risk mitigation” recommendations to financial institutions, which – if not in the form of specific designation lists – should contain “extremely high-risk client profiles” closely resembling those of undesirable corrosive capital principals.
- Start monitoring and analyzing financial transactions and money flows in real time. The EU and BG AML regulations allow and actually envision such a system. No one cares to create and use it, though, at least not in BG. The Bulgarian National Bank has access to all the data in real time, but does not share it with the State Security Agency and with the National Revenue Agency (and vice versa), although all three entities are explicitly tasked with enforcing AML/CFT regulations in the law.
- Have regular meetings with the top management of financial institutions reinforcing the political message – if you step over the line, you are done. Those who have gone over a “red line” should be called in “for an interview” and required to close the relationship they have started immediately.

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