Money Laundering Regulation and Bank Compliance Costs: What Do Your Customers Know? Economics and the Italian Experience

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INTRODUCTION

The objective of this paper is to illustrate the link between the effectiveness of the anti-money laundering regulations and the characteristics of the compliance costs involved for banks. The work is set out as follows. The next section describes the economic framework, which starts with the assumption that intermediaries have an advantage in terms of information and then demonstrates, by means of a principal–agent model, how this advantage can produce collective gains in the war against money laundering only if the regulations take the problem of compliance costs into due consideration.

Based on the economic results, the following section presents empirical evidence, comprising a survey conducted in conjunction with an Italian bank with branches in 11 out of Italy's 20 regions, on how banks perceive the relationship of customers to the obligations imposed by the anti-money laundering regulations. The survey provides a better understanding of the nature and extent of compliance costs within banking operations. The final section contains the concluding remarks.

THE ECONOMIC ANALYSIS

In our analysis, we examined the case of unaware intermediaries, ie respectable banks, through whose countless transactions, both deposits and withdrawals, third parties may attempt money laundering manoeuvres. Money laundering manoeuvres, however, if in fact the intermediaries are honest and above board, can leave traces and constitute anomalies in banking and financial accounts, for which the authorities find it efficient to request the banks to *collaborate*. The more effective this collaboration, the lower the money laundering risk will be.

While the central theme vis-à-vis corrupted intermediates is one of *deterrence*, the principal effects in terms of money laundering risk, given the existence of anti-money laundering regulations designed to obtain the collaboration of honest intermediaries, the success of these regulations will depend on how *acceptable* they are to those intermediaries. In this case, the existence of national anti-money laundering regulations lets us overlook the individual territory of analysis in the economic framework.

The initial hypothesis is that any form of regulation tends to alter the structure of the incentives, and thus the conduct, of the intermediaries. The effectiveness of regulation thus depends on the ability to influence the decision making of bank employees in the proper direction.

The term 'acceptability', in other words, can indicate an issue which is central to all banking and financial regulation, and thus for anti-money laundering: when influencing the structures of the incentives of intermediaries, it must avoid producing conduct on their part which is not effective, or is even counterproductive, in terms of the effectiveness of the regulation. A decline in regulatory effectiveness results in the growth of money laundering risk.

The possibility that the regulation generates counterproductive effects dependent on the degree to which it is accepted by the regulated intermediaries is a general phenomenon, given the existence at least of regulation-related *compliance costs*, ie the charges arising from the very existence of rules and regulations, which produce risks of avoidance.

As the cost of regulation rises, the level of its acceptability to intermediaries declines, which implies an alteration in the structure of incentives and conduct, thus distorting the objectives of regulation. The bottom line is that, for each regulation system to be effective, it must possess a sufficient level of acceptability to the regulated intermediaries. The costs of anti-money laundering regulation must be weighed against the gains expected from regulation, so that the final net result is a decrease of money laundering risk.

A distinction must be made, however, between expected gains at the system level and expected gains for the individual agents, for both the regulation aimed at defining the honest intermediary as *agent* and for that aimed at deterring *criminal* intermediaries.

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At the aggregate level, Masciandaro (2000a, b)[1] shows that there is a clear incentive for the economic system as a whole and for the industry of regulated intermediaries in particular to accept favourably the rules which present a deterrent for potentially *corrupt* intermediaries. Furthermore, Baity (2000)[2] correctly points out that the financial institutions must come to understand that they are also stakeholders in upholding the integrity of the financial system. We need to recognise that integrity is a public good, and that we have to implement the necessary regulations in order to avoid the free-rider behaviour risks.

Less obvious is the formulation of anti-money laundering regulations for which the net expected gains are positive, when the problem of assigning precise tasks to the intermediaries arises. The assignment or delegation of these tasks, understood in terms of economic theory, demands the characteristics of an intermediary who is an *agent* of the public authorities.

Masciandaro (1998, 1999)[3] stressed that the banking and financial industry is essential for the development of crime and corruption, since it is a primary vehicle for money laundering activity. Banking and financial means of money laundering play an essential role in the growth of criminal activity as a whole, by separating liquid funds from their illegal origin and permitting their reinvestment in activities, either legal or illegal. The more the characteristics of risk and return encourage reinvestment in illegal activities, the more the demand for money laundering will increase, thus exalting the role of money laundering as the multiplier of criminal activity.

This process can be hindered if money laundering activity involves costs for the criminal parties. All other conditions being equal, the more effective anti-money laundering regulation is, the more the costs of money laundering will rise.

It should be noted that the collaboration required of intermediaries in terms or reporting and monitoring has become increasingly more difficult, in line with the progress in money laundering techniques. Let us reconsider the definition of money laundering with regard to any financial transaction: this transaction not only performs an economic function of its own, it also performs an additional and *anomalous* one as well.

The hypothesis is, that precisely because the transaction in question is responding to unusual (and illegal) purposes, it will be characterised by anomalous elements when compared to its normal physiological features.

What is the source of the anomaly? It could derive from at least one of the basic elements in the definition of money laundering: an economic *actor* sets in motion *procedures* to transform a given *amount* of potential purchasing power into cash. The anomaly could therefore refer to at least one of the three elements of a given banking or financial transaction, namely actor, procedure or amount.

The progress made in money laundering techniques has brought greater difficulties in identification and monitoring, precisely because it has made the concealment and separation of the three component parts of a money laundering transaction increasingly effective. We could compare, for example, a traditional money laundering transaction, the *spallone*, with more sophisticated ones like 'offshore' and 'online' money financing.

Thus the first important point to note is the growing difficulty in trying to recognise the *laundering anomaly*. Secondly, it is essential to remember a banking and financial transaction may present elements of irregularity even when it is not related to any attempts at money laundering. Anomalies may be regarded as necessary, but not sufficient, conditions for detecting money laundering activity.

What role then, can intermediaries play in reducing the vulnerability of the legal markets to attempts at corruption? The answer, as this paper will endeavour to demonstrate in this section, can be found by inserting two keywords into the banking and financial industry equation, utilising economic analysis: *information* and *incentives*.

The effectiveness of anti-money laundering regulation, and thus, the greater impermeability of the banking and financial system, depends on the first of the two keywords identified: information. We must bear in mind, as we did in the previous pages, that the peculiarity of the criminal activity in question is that it is conducted in markets dominated by various forms of information asymmetry in which the intermediaries operate. According to the analysis of Filotto and Masciandaro (2000),[4] the information capital of the intermediaries places them in such a position so as to make it efficient to delegate to them the function of 'agents', namely to detect and report cases of money laundering.

The 'agent' intermediaries, supervisory authorities and customers produce a series of situations where

information is incomplete (nature of the customer, nature of the intermediary, his diligence in performing his function as an agent, environmental factors independent of the conduct of either customers or intermediaries). Therefore, the central problem of anti-money laundering regulation, as Masciandaro (1995)[5] pointed out, would be to design a system of procedures and incentives which induces the 'agent' intermediaries to act effectively with regard to the production of the necessary information. In this respect, we agree with the view[6] that banks should be allowed to operate the various rules with discretion, allowing them to achieve a balance between the need to detect money laundering and pursuing other goals, such as confidentiality.

In other words, the regulation must influence the actions of intermediaries in the right direction, avoiding the risk of deviant conduct. This risk is not theoretical. As stressed earlier, one problem of regulation is trying to prevent its expected costs from exceeding the expected gains, thus encouraging distortions or even avoidance by those agents who do not 'accept' this system of rules.

It must be stressed once again that it is not sufficient for regulation to appear effective just at the aggregate level. The macroeconomic advantages of anti-money laundering regulation, represented by greater stability and efficiency in the uncorrupted financial system, does not automatically ensure effective conduct on the part of the individual intermediaries, who might undertake conduct typical of 'free-riders'.

In fact, for the individual intermediary, there is a concrete trade-off between the function of agent and the relative costs, in terms of both information management and transmission, and the traditional 'asset' of confidentiality. As Antoine (1999)[7] noted in the case of offshore centres, confidentiality is still an economic asset in the banking and financial industry, both at national and international level. The more the definition of the role and obligations of intermediaries in the anti-money laundering function has no effect on their incentives, the greater will be the risks that each of them will find it optimal to expend the minimum effort, counting perhaps, on the fact that others will produce the necessary efforts, or even on the competitive advantages of not trying. But if each finds it optimal not to expend any effort, then no one will.

The design of effective regulation must therefore consider the second keyword: incentives. The intermediaries must find it optimal to effectively perform their function as 'agent'. However, given the characteristics of intermediaries as complex organisations, analysed in the pages which follow, and their numerous relationships with various supervisory institutions, the system of rules must be able to exert a positive impact on the resources deemed important by the intermediaries, all other conditions being equal (including fines and other penalties). If the regulation designed is incentive compatible, the bank disclosure strategy is easier to implement. It is important to remember, as Moscarino *et al.* (2000)[8] did, that in general, any decision to disclose can only be made after a fair, analytical and practical assessment of the facts and consequences, in line with the corporation's policies, remedies and culture. It must be added that all these variables are more or less dependent on the rules of the game.

Among these, it is important to mention the possible role of reputation. If an intermediary operates in markets that assign value to its endowments, be they linked to profits, assets or reputation, the regulation must then take them into consideration. It will then be the intermediaries themselves who are driven to ensure that the structure of their internal incentives, attached to the various positions (from manager to counter clerk), moves towards the active and effective collaboration in the fight against money laundering.

THE EMPIRICAL ANALYSIS

A reconstruction of the characteristics of Italian laws based on the economic framework defined in the previous section reveals a sort of double paradox.

On the other hand, there is what we might call a 'collaboration paradox'. All the anti-money laundering regulations, from 1991 to the present, are based on the concept of active collaboration by the intermediaries, ie autonomous conduct aimed at reporting abnormal situations in the management of financial flows. The results of applying this principle have not been encouraging thus far.

The reason for this? Economic analysis provides an indication: any individual undertakes active behaviour only if this produces some advantage, ie if the suitable incentives exist for adopting a given conduct.

The 'incentive approach' based on the principal–agent approach, teaches us that if the conduct of a certain economic actor is not as expected or hoped for, the reason must be sought by analysing the

game rules, formal and informal, which condition and guide that actor.

In the present case, the game rules are represented primarily by the anti-money laundering laws. Thus the anti-money laundering laws have not created the incentives necessary to guide intermediaries toward the desired conduct.

The problem is therefore in trying to seek a better understanding of the characteristics and business requirements of the intermediaries, and then, to find the right incentives and opportunities for implementing the principle of active collaboration.

To do this, we must start from what is, or should be, the business mission of any intermediary: maximising the return on capital invested. Such a business mission consequently implies product strategies, on the one hand, and the use of production factors, on the other, which are optimal from the standpoint of efficiency.

If the intermediary has such a business mission, what happens if the public authority asks it to perform an additional task related to a general need of primary importance? The intermediary will most likely assess what the expected costs and expected gains are that may be generated by the task, and if the algebraic sum is positive, will actively collaborate.

Now let us evaluate in this light the salient aspects of the Italian anti-money laundering laws. In terms of expected costs, we can identify two major cost categories:

(1) *Technical operational or tangible or internal costs*. These relate to all those investments within the company in the form of physical and human capital which are necessary to effectively perform the new task.
(2) *Reputation or reprisal or intangible or external costs*. These are associated with the impact which the new task may have on the intermediary's relations with its customers as a whole and in the management of both loans and deposits.

In this case it is absolutely acceptable that the intermediary is asked to use information capital which is private, essentially that relating to its customers, for public purposes.

In principle, each intermediary may unknowingly carry out transactions or offer services, to individuals whose income is, at least in part, of illegal origin. There is a significant problem however, in 'signal extraction'. In fact, the following hypotheses must be true:

— if the transaction performs an illegal function (money laundering) as in place of, or along with its normal legal function, this characteristic must be reflected as an anomaly in the transaction (anomaly hypothesis);
— if this anomaly exists and is recognisable, it must be univocally attributable to the illegal function (univocal hypothesis).

In other words, it must be borne in mind that the particular nature of the goods handled in the banking industry, that they are fiduciary goods *par excellence* and are therefore intangible, makes the risk of error rather probable — errors of both the first and second type.

Errors of the first type are committed when the anomaly hypothesis does not apply, so that a transaction which performs an illegal function in addition to, or in lieu of its legal function, displays no anomalous features or characteristics. The higher the probability of type one errors, the less effective the performance of the anti-money laundering task will be, tangible and intangible costs being equal.

Errors of the second type are committed when the univocal hypothesis does not apply, so that a transaction with anomalous features does not conceal an illegal function. The higher the probability of type two errors, the higher the expected intangible costs will be (in terms of risks of losing reputation with the customer), tangible costs being equal.

It should also be observed that by their very nature, money laundering transactions are often effectively disguised and appear highly changeable and variable over time and space. For this reason, the taxonomic classification of transactions (provided in the CD-ROM 'Decalogo') may be no more than indicative and subject to rapid obsolescence. As a result, the symptoms from which intermediaries should suspect cases of money laundering are often confusing and unrelated to reality or to specific operational cases. The armoury of 'warnings' available to the intermediaries is therefore of little use and may cause them to commit errors. Therefore, they are forced to adopt an extremely cautious approach which minimises the number of reports.

Lastly, even in a context where the probability of errors of the first or second type is nil, there is the

possibility that risks of reprisal may emerge, given that a proper report provides the authorities with information on an individual whose income is all, or in part, of illegal origin.

Furthermore, and here we find the second paradox, having focused the attention of the laws exclusively on banking and financial intermediaries, the expected intangible costs may increase. If the banking intermediaries, because of their anti-money laundering duties, experience an additional demand for information, this may have unexpected, undesired effects on their customers. Consequently, this will reduce the very effectiveness of the laws, without reducing the cost to the intermediaries.

This could be compared to a 'communicating vessel' effect: despite severe laws present in one 'vessel', the illegal transactions are effected anyway, taking advantage of the laxity in the other 'vessels'. The channels for money laundering are not confined to banks, as was noted by Bruton (1999) and Wright (2000).[9] In this sense, the direction taken at the community level seems appropriate: it extends the obligation of reporting to parties who are non-financial, but who because of the nature of their activities, lend themselves to money laundering purposes.

Having identified the possible sources of costs which the anti-money laundering task may generate for the individual intermediary, we now ask ourselves what gains can be expected from this legislation.

First, the possible information gains have been mentioned several times. The need created by the law to assume greater information on customer transactions in some cases increases the sum of information which the intermediaries have on their interlocutors, improving their chances of placing financial and credit products in the most advantageous and efficient way.

Secondly, there are expected gains associated with minimising the risks of penalties for non-performance of the anti-money laundering task. If the authorities detect through means other than the (failed) reporting of anomalies, the presence of illegal transactions, legal sanctions (pecuniary and criminal) would be issued against the parties responsible.

Therefore, intermediaries should offset the information and 'insurance' costs associated with minimising the possibility of incurring sanctions against the various tangible and intangible costs.

The actual or anticipated value of these expected gains is problematic. The fact is that they certainly do not compensate for the expected costs, given the insufficient active collaboration denounced by the authorities.

Furthermore, it seems unlikely that the sources of these gains could be significant and further increases in effectiveness must be obtained, perhaps, through changes in the laws.

As far as information gains are concerned, in a context where the competition is increasing, the incentive for credit institutions to collect information, useful for better placing their payment, lending, and general financial services, is an established fact and therefore requires no further stimulus.

The authorities are incapable of enriching this type of information capital and have thus far abstained from making available to intermediaries, with the appropriate timing and procedures, any other sort of information which might be useful in preventing fraudulent conduct on the part of their customers. This refers either to information collected by the police or to data kept in the archives of various institutions (lost and stolen documents, electoral rolls, fiscal codes, false names used, false company names, etc) which might be channelled into a central database made available to financial intermediaries and which would constitute, as in other countries of the EU (UK, the Netherlands and others), an effective instrument for preventing banking fraud. This type of contribution would compensate, if only partially, for the cost sustained by intermediaries in collecting and channelling which is at the moment, a unidirectional flow of information to the authorities.

Regarding the gains from insurance against the risk of incrimination, it would be counterproductive to seek to increase them, for example, through a harsher penal approach to the problem. The reasoning is easily explained.

One result that has been demonstrated in both economic analysis and legal provisions is the reduced effectiveness of the penal approach in the banking and financial industry, given the particular nature of the goods and services provided. It results, among other things, in growing difficulties in reconstructing *a posteriori* situations that occurred *a priori*, and this leads to corresponding problems when trying to attribute actual roles and responsibilities.

A closer examination of the expected costs and benefits which the anti-money laundering tasks can produce for the individual intermediary seems to suggest a clear explanation for the reduced effectiveness

of regulation.

We need to identify a strategy which will reduce the expected costs of regulation and/or increase the expected gains from it.

For this purpose, given the difficulty of quantifying the tangible costs, it is essential to have a better understanding of the intangible costs. This will involve examining the impact of the anti-money laundering laws on the bank–customer relationship.

To that end, with the collaboration of an Italian federal bank, a survey questionnaire was formulated and sent to the managers of almost 400 bank branches located in 11 regions of the country. Managers responded to it during the period September–November 1999. That questionnaire contained a series of questions aimed at obtaining information useful for better evaluation of the expected costs of anti-money laundering laws.

This study presents all the virtues and defects of indirect surveys. It is an indirect survey because party A (the bank manager) is asked for evaluations on the attitude of party B (the customer) regarding certain topics. In this case, the defects of this type of survey are minimised the following are considered: the interest of the survey focused on the conduct of type A parties (bank managers) whose expectations and beliefs depend on the behaviour of type B parties (bank customers). This was precisely the object of the survey.

The questions asked of the bank directors in the questionnaire, their responses and analytical comments are shown below. This will be followed by some overall considerations.

Question (1) What percentage of your customers are aware of the existence of anti-money laundering regulations in the bank, with relative obligations of recording and reporting for bank personnel (indicate a percentage between 0 and 100):

The responses indicated that according to the bank managers an average of 47.55 per cent of the customers were aware of the regulations (variance 22.36 per cent, mode 60 per cent).

Considering the complexity and novelty of the regulations, a value close to 50 per cent certainly seems satisfactory; expectations in this regard were lower. This should make it possible to further increase the level of awareness, within a reasonable time period, and thus reduce the negative impact of the regulations on the banks in commercial terms.

In fact, the more widespread was awareness of the regulations, the lower the expected tangible and intangible costs to the intermediaries. All other conditions being equal, greater awareness can reduce the expected intangible costs. One condition must be borne in mind, however: the increasing levels of awareness should not reduce the quality of awareness. In other words, customers must be properly informed.

In order to secure more information on the quality of the awareness attributed to customers, we had to ask what the sources and characteristics of this awareness might be. Hence:

Question (2) On average, customers become aware of the existence of anti-money laundering regulations through (select only one answer):
(a) personal experience
(b) information prepared by the bank
(c) information prepared by public offices
(d) information from the media.

The fact that the bank managers felt that direct and personal experience (48 per cent) prevails over information generated institutionally by the bank (41 per cent, still considerable) suggests that informative action might help increase the level of awareness significantly. Also note that the managers felt that information on this subject is generated almost totally by banks (88 per cent). The information produced by public offices and that channelled through the media was held to be virtually nil.

Informative action, which serves to reduce the expected tangible costs, and intangible ones of the future, can therefore have a short-term effect on the expected tangible costs in terms of investments in training and supports of various kinds. If the net effect is to be positive, the tangible costs should not be borne financially by the banks.

The average customer seems to learn of the existence of the anti-money laundering laws primarily through contacts with his/her bank. But what is their perception of these regulations?

Question (3) On average, among customers who are aware of the existence of the anti-money laundering laws, what objective do they think the government is pursuing? (select only one answer):
(a) combat organised crime
(b) increase banking transparency
(c) combat corruption

(d) reduce banking confidentiality
(e) combat tax evasion
(f)combat usury

Though the managers felt that a significant proportion of customers properly interpret the objectives of the laws (43.36 per cent), the feeling was that a relatively large segment of customers improperly associate the law with objectives, direct or indirect, of a fiscal nature (against banking secrecy 44 per cent, against tax evasion 1 per cent). It is also possible that some relationship of significance may exist between the perception of a final objective (war against crime) and that of an underlying objective (war against banking secrecy).

The fact remains however, that all other conditions being equal, this widespread perception of an underlying objective is discouraging, because, by definition it is opaque and ambiguous as it can be linked to more than one final objective.

This suggests that the objective of any informative action must be to rectify the widespread perception of customers that the laws were passed for improper purposes. In this vein of thought, we must reflect perhaps, on the advisability of a legislative review in this direction if it is deemed useful to eliminate the ambiguities. This corrective action is probably more complex than simple informative action.

An improper perception of the purpose of legislation increases the expected intangible costs: customers' hostility towards the collection of information is heightened, with an increased risk of intolerance in the case of errors of the second type by intermediaries. The intermediaries seem well aware of this.

In a natural progression, the next question concerned the facts which contributed to the customers' ambiguity in perceiving the purpose of the legislation.

Question (4) In your view, what is the reason for this misperception of customers regarding the purposes of the anti-money laundering laws? (select only one answer):
(a) personal experience
(b) information provided by the bank
(c) information provided by public offices
(d) information provided by the media

It is interesting to note how answers to Question (4) differ from those obtained under Question (2). Here, the role played by the media comes to the forefront (31 per cent), while information from public sources continues to be absent. The fact that the communicative action of public administration is viewed as insignificant makes enforcement more difficult. It would be important to determine whether the incorrect perception of the purposes is related to the personal experiences of the individual, to the actions of the media or to ineffective bank information.

To this end, the responses to Question (3) were compared with those to Questions (1) and (6). The result was clear: customers were more inclined to perceive correctly the purposes of the regulations (combating crime) when they were informed through the bank.

Ambiguity and opacity of a law may depend not only on the sources of information, however, but also on the actual behaviour observed in the venues (in this case, the banks) where the law has thus far been most frequently applied.

Question (5) The anti-money laundering regulations impose recording and reporting obligations on the banks. Based on your experience, do customers generally perceive the fulfilment of those obligations as (answer yes *or* no *for each situation):*
(a) variable from region to region?
(b) variable from bank to bank?
(c) variable from counter to counter in the same branch?

If the law is not uniformly applied (as suggested by the slight majority of *yes* answers with 54 per cent), this creates conditions of unequal competitiveness and the prerequisites for an incorrect perception of the nature of the obligations. If this is true the situation would require careful attention. When efforts to fulfil certain functions are not synchronised, this could result in undesirable forms of conduct. First, from the viewpoint of the customers: if furnishing information is perceived as a burden, and the severity of this burden varies from one intermediary to another, customers will tend to prefer the less demanding intermediaries. All other conditions being equal, this increases the expected intangible costs for intermediaries who are more diligent in exercising their anti-money laundering duties. Consequently, this could trigger the phenomenon known in the literature as 'competition in laxity'. The more diligent intermediaries, penalised by this fact, might find it advantageous to adjust their conduct 'downwards'.

There seems to be uniform conduct with regard to the procedures defined by the bank. Greater discrepancies are noted between branches in the areas of highest concentration. In this case, more so than in other cases, the answers may be influenced by differences in attitude.

Question (6) To fulfil their legal obligations, banks request and record information from their customers. In your view, this activity by the banks is generally perceived by customers as being aimed at compliance with:
(a) a legal obligation, in the interest of customers
(b) a legal obligation in the interest of the bank
(c) a legal obligation in the collective interest (the war against crime)
(d) a bank requirement, in the interest of customers
(e) a bank requirement, in the interest of the bank
(f) a bank requirement in the collective interest (the war against crime)?

The bank managers seemed to feel that the information collecting activity was generally perceived correctly (60 per cent). It should be noted that this percentage is higher than that associated with the purpose of the legislation (44 per cent, Question 3).

The two figures appear to be in contrast. An alternative explanation could be the following: in the process of collecting information, bankers have the chance to 'correct' mistaken perceptions of customers regarding the purpose of the anti-money laundering legislation. If the explanation were the latter, it would strengthen the 'public' role of the bank as a disseminator of public utility information.

Thus, the customers seemed to have a fairly accurate perception of the nature of the compliance, even though in almost 20 per cent of the cases they failed to identify the purposes properly. This reduces, but does not nullify, the possibility that other institutions could use the lack of enforcement for competitive purposes.

The collection of information for anti-money laundering purposes can have a positive impact in terms of public utility and company equity. But there is a risk, as examined in the next question.

Question (7) To comply with legal obligations, banks record and collect information from customers. How big is the risk that the average customer regards this activity as a violation of his confidentiality (indicate a percentage between 0 and 100)?

The mean figure (44.5) is decidedly high. There is thus a rather prevalent perception among bank managers regarding the risk of a negative reaction to the collection of information on the part of the customers. Customers, though not attributing the responsibility for the procedure to the bank (see Question 6), may still be irritated with the bank (which is already associated with other problematic connotations, due in part to other legislative provisions such as the recent anti-usury law). In this case, all other conditions being equal, the expected costs of errors of the second type are higher.

Among the conditions subject to change, however, a central role is played by the sensitivity which the average customer may attribute to his confidentiality. For this reason, it might be advisable to examine in depth the perception of bank managers regarding the causes for the average customer's attitude.

Question (8) Bank customers will be more willing to accept regulations which reduce their confidentiality if they approve of its purposes. For the average customer, how important is it to combat (assign a score from 0 to 10):
(a) organised crime
(b) corruption
(c) tax evasion
(d) usury?

Since the highest value corresponds to the real purpose of the anti-money laundering laws (combating organised crime), it is essential to correct the distorted perception of customers, who in the majority of cases (compare the responses to Question 3), associate the laws with objectives other than institutional.

This confirms the need to take every possible measure: at bank level, in the intervention and guidance policies of the authorities, and even, if necessary, at legislative level namely to reduce and even eliminate any ambiguity regarding the purposes of the regulations. The greater the importance which customers assign to what we might call their 'confidentiality asset', the greater the benefits will be.

But how important is this asset in the decisions of customers? Since it is an intangible asset, unlike interest rates and the technical characteristics of banking and financial products in general, it is rather difficult to measure. Nonetheless, it is interesting to know how important bank managers perceive confidentiality to be for their customers. So it is important to delve deeper into this aspect.

Question (9) Each customer demands of his bank: (a) service quality, (b) reasonable rates, (c) assurances of confidentiality. For your average customer what is the relative importance of (a), (b) and (c) (distribute a total of 100 among the three items)?

Confidentiality is certainly a characteristic which is closely intertwined with other intrinsic and economic aspects of banking services. But the mean value of 28.54 seems rather high and, if considered together with the result of the preceding questions, shows the high risk of producing ineffective regulations.

In fact, growing competition in the market these days for banking and financial products does not seem to exclude the confidentiality asset. If this is the perception of bank managers, it means that the anti-money laundering laws affect an important aspect of the bank–customer relationship. The responses obtained also seem to confirm that the increasing diffusion and utilisation of information among customers does not diminish the sensitivity of each operator with regard to the protection of his personal information capital. Within the heterogeneous category embraced by the noun 'customer', however, is it possible to pinpoint differences in terms of sensitivity to confidentiality? To examine this specific aspect, it is necessary to ask a series of questions.

Question (10) What value do the following assign to confidentiality assurances (assign a score from 0 to 10):
(a) companies (b) private individuals?

Question (11) What value do the following assign to confidentiality assurances (assign a score from 0 to 10):
(a) small companies (b) medium-sized and large companies?

Question (12) What value do the following assign to confidentiality assurances (assign a score from 0 to 10):
(a) adults (b) young people (c) the elderly
(d) men (e) women?

Question (13) What value do the following assign to confidentiality assurances (assign a score from 0 to 10):
(a) the self-employed (b) employees?

Question (14) What value do the following assign to confidentiality assurances (assign a score from 0 to 10):
(a) Italian customers (b) non-Italian customers?

The data show that confidentiality becomes important as the retail characteristics of the customers increase (individuals more than companies, small companies more than large, self-employed more than employees, Italians more than foreigners). This could prompt various conclusions.

First, the more a bank focuses its attention on the retail markets, the more sensitive it is to the intangible costs of the anti-money laundering laws. In particular, this could mean that local banks are highly sensitive in this sense, characterised as they are by a special relationship with their geographical area, usually influenced in turn, by a strong propensity to household saving on the one hand, and by an industrial structure of small and medium-sized companies on the other. It would be interesting from this standpoint to propose an analysis of the 'propensity to report' demonstrated by the Italian banking system, operating not only by geographical breakdown, but also distinguishing among the intermediaries by juridical category. These patterns might also be useful for understanding how to manage informative action aimed at correcting customers' perceptions regarding the actual purposes of the legislative provisions.

Up to this point, we have analysed the perceptions of bank managers on the correlation between anti-money laundering laws and customer attitudes. No less important, on the other hand, is the impact of these regulations on the operations of the intermediaries. Some in-depth examination may then be of interest.

Question (15) The record-keeping obligations associated with the Unified Anti Laundering Database impact in various ways on branch operations. How do these obligations affect branch operations in terms of (assign each item a point score of 0 to 10):
(a) IT compliance (b) bureaucratic compliance
(c) organisational aspects (d) training aspects

Question (16) The reporting obligations associated with the anti-laundering regulations impact on branch operations in various ways. How do these obligations affect branch operations in terms of (assign each item a point score of 0 to 10):
(a) IT compliance (b) bureaucratic compliance
(c) organisational aspects (d) training aspects
(e) reputation risks, in case of erroneous reports
(f) reprisal risks, in case of correct reports

The responses to the questions most directly linked to branch operations seem encouraging. On the whole, the impact on the various operational aspects seems generally limited and uniformly distributed (values between a minimum of 5 and a maximum of 6.4). The minimum value was associated with the organisational impact of the anti-laundering regulations. The relatively most important effects were identified as the reputation risks and the risks of extortion. The perception of these risks was basically homogeneous in all the regions.

We also verified whether the responses of the bank managers to the two questions asked here displayed any discernible pattern. Making all possible comparisons between the responses, we obtained the following results: (1) on average, branch managers sensitive to the impact of the anti-laundering laws on branch operations were sensitive to all categories of 'burdens'; (2) those who expressed particular sensitivity to a given category of 'burdens' generally reported it for both questions (except, of course, for the risks of reprisal and reputation, present only in the question regarding reporting obligations).

The results therefore confirmed our belief that intangible costs are the most serious obstacle to the effectiveness of the anti-laundering laws, based on the correct approach of active collaboration.

We therefore reported that the principle of active collaboration is rendered problematic by the question of 'signal extraction'. In fact, for the approach to express all its effectiveness, the following hypotheses must be simultaneously true:

— if the transaction performs an illegal (money laundering) function that replaces or accompanies its usual legal function, this characteristic must be reflected in an anomaly of the transaction (anomaly hypothesis);
— if this anomaly exists and is recognisable, it must be univocally attributable to the illegal function (univocal hypothesis).

Furthermore, it is assumed that an anomaly in the transaction–customer combination can be recognised if the customer is well known.

Question (17) The reporting obligations derive from an assumption that each bank is totally familiar with the economic and financial conduct of its customers. What actual degree of familiarity does your branch have, on the average, with its habitual private customers? (assign a score from 0 to 10).

Question (18) The reporting obligations arise from an assumption that each bank is totally familiar with the economic and financial conduct of its customers. What actual degree of familiarity does your branch have, on average, with its habitual business customers? (assign a score from 0 to 10).

The responses reveal a potential problem, at least as perceived by the bank managers: is the true information level of the banks overestimated? The level of familiarity with the economic and financial conduct assumes rather low values (though higher for companies than for private individuals), such as to make the identification of abnormal actions potentially more difficult on average.

It is also important to investigate how true to the hypotheses of anomaly and univocalism are.

Question (19) The reporting obligations derive from a second assumption: if a banking transaction conceals a money laundering transaction, it will display anomalous features. How likely is this assumption (assign a score from 0 to 10)?

The mean value was above the median: a level that seems to suggest that, in the perception of the bank managers, the hypotheses of anomaly and univocalism can be assumed but with considerable caution. In other words, in applying the principle of active collaboration, proper weight should be attributed to the problem of 'signal extraction'.

On the subject of the impact of anti-laundering laws on branch operations, we then wished to measure reactions to a specific proposal.

Question (20) In signalling suspicious operations, a formalisation of the relationship between the branch manager and his co-workers would be:
(a) a highly negative innovation
(b) a negative innovation
(c) neutral
(d) a positive innovation
(e) a highly positive innovation.

The sum of the 'positive' and 'highly positive' options exceeded 85 per cent, so there is no doubt about the validity of the procedure, as perceived by the branch managers, who probably view such an

innovation as enhancing the sense of responsibility of the internal structure.

Having exhausted these queries related to what we have called the first paradox of the Italian anti-money laundering laws — ie active collaboration that seems 'inactive' — it may be useful to attempt an examination of the second paradox, ie selective collaboration. We have already discussed how if banking intermediaries, because of their anti-laundering duties, are characterised as requiring more information than other service providers, this may have unexpected and undesired effects on their customers, thereby reducing the very effectiveness of the regulations without reducing the costs to intermediaries.

Question (21) The recording and reporting obligations are borne today exclusively by intermediaries. To improve the fight against money laundering, these obligations should be extended to:
(a) notaries
(b) foreign exchange operators
(c) the jewellery and precious metals industries
(d) the real estate sector
(e) (free response).

The responses generally indicated the advisability of extending the obligations to other parties. The managers indicated professionals as possible assignees of the regulations (in many provinces the value was 100 per cent) and also considered the real estate sector as significant. With reference to the latter, it probably involves subjecting the buying-selling market to controls.

This confirms the existence of a widespread perception that the duties related to the performance of a public utility function are not equitably distributed among private enterprises. In this sense, the indications that have emerged at the European level regarding the extension of reporting obligations to sectors and professions other than those related to the banking and finance industry should be rapidly incorporated into law.

Lastly, it seemed advisable to propose some questions on the features of the recent reform of 1997 mentioned earlier. Specifically:

Question (22) With the reform of 1997, when reporting suspicious transactions, the bank's interlocutor is no longer police headquarters but the UIC (Italian Currency Control Office). Your assessment of this change is:
(a) highly negative
(b) negative
(c) neutral
(d) positive
(e) highly positive.

It is noteworthy that the positive assessments greatly prevailed over the negative (particularly in the southern regions), with 'highly positive' receiving the most votes. There were a certain number of 'neutrals'. This neutrality could reflect a wait-and-see attitude, associated with the need to see the new structure of relationships operating 'at full scale'. The basic hypothesis is that the change in interlocutor — from an outsider for the banking industry like the police to an insider authority like the UIC — should make application of the principle of active collaboration more effective by reducing both tangible and intangible expected costs. In this sense, it is logical to ask whether:

Question (23) The assessment expressed in Question 22 depends on the fact that the change in interlocutor affects:
(a) IT compliance
(b) bureaucratic compliance
(c) organisational aspects
(d) training aspects
(e) reputation risks
(f) risks of reprisal.

The assessments expressed in the responses to the preceding question seem, on average, to derive from a simplification of procedures, and thus from internal aspects associated with tangible costs, and from external factors, associated primarily with intangible costs, although the former seem to prevail strongly over the latter. It should also be noted that the value of the 'risks of reprisal' was significantly higher in the southern regions.

To examine in greater depth the reasons behind the assessment of branch managers on the reform of 1997, we tried crossing the responses to Question 22 with those of Question 23. The results are interesting. First, there is a strong correlation between those who said they were favourable (or highly favourable) to the reform of 1997 and the attention to organisational factors and reprisal risk factors. Therefore, if the purpose of the 1997 reform was to reduce the tangible and intangible costs of the anti-laundering obligations, the assumptions are encouraging.

Secondly, there is a strong correlation between those who declared themselves neutral and focused on the bureaucratic aspects of the regulations. This

might signify that definite advantages in terms of acceptability of the reform by bank managers, and thus its effectiveness, will depend on how it is actually managed, in terms of formal and bureaucratic compliance.

In conclusion, it may be interesting to pose a few questions on another important aspect of the 1997 reform.

Question (24) The 1997 reform contemplates a feedback flow from the UIC to the banks, both on aggregate and related to individual reports. Your assessment of this change is:
(a) highly negative
(b) negative
(c) neutral
(d) positive
(e) highly positive.

Question (25) The assessment you expressed in Question 24 depends on the fact that the innovations affect:
(a) IT compliance
(b) bureaucratic compliance
(c) organisational aspects
(d) training aspects
(e) reputation risks
(f) risks of reprisal.

The assessment of the institution of a feedback flow from the authorities to the intermediaries, contemplated by the reform, was decidedly and uniformly positive. This opinion was once again linked to obvious simplifications of a procedural and organisational nature.

To gather more information on this aspect of the assessment of the 1997 reform, we tried crossing the responses of Questions 24 and 25 with those provided to the questions on the 'burdens' that may emerge for intermediaries from the anti-laundering obligations (Questions 15 and 16). The result was encouraging: on average, the more a manager was sensitive to these burdens, the more positively he assessed the reform. This might signify that there is room to improve the relationship between intermediaries and sector authorities and make it more productive, with advantages both for the specific objective of efficiency and for the general objective of defence of legality.

CONCLUSIONS

In light of the results obtained from the survey, some final reflections are formulated here.

It must first be stressed that an economic analysis of money laundering and the relative regulation can indicate how to properly guide the conduct of intermediaries, for the purpose of marrying up the efficiency of their conduct with effectiveness in the pursuit of public utility objectives.

The model of analysis examined the case of honest (or unaware) intermediaries, whom the legislators regard as the fulcrum of the anti-laundering regulations. An honest bank is interpreted as an economic organisation oriented toward the maximisation of profit, which has specific information on the economic actors operating in a given geographical area.

The rationality of the bank is reflected in the desire to maximise the difference between revenues and costs. Therefore anti-laundering regulation, if it wishes to influence the conduct of agents, must start from the realisation that it must have a balanced impact on their income and expense structure, considering that regulation in any case increases costs. The anti-laundering duties, in fact, require banks to incur two types of costs: investments in capital (physical and human) and reduction in confidentiality toward customers (strategic *assets* in banking activity).

In the analysis of the honest agent, two questions play a crucial role: distribution of information and incentives. The first is crucial in designing effective regulation from three standpoints: the importance of the agent's insider information, non-verifiability of the effort (onerous) of the agent in anti-laundering action, and non-verifiability of the incidence of exogenous factors on the effectiveness of regulation.

As Alexander (2000) shows in his study,[10] the trend in the national and international anti-money laundering regime is characterised by the fact that the public authority chooses to counter money laundering by using banks, because of the specific nature of their information capital, delegating to them the anti-laundering identification and reporting action (under the assumption which characterises all the anti-laundering laws, that money laundering attempts by criminals will leave a trace, an anomaly, that the bank can detect because of its insider knowledge).

The action is performed by the agencies with an effort (onerous) that the lawmaker cannot observe directly but on which the efficiency of the anti-laundering will largely depend. The second information problem, the non-observability of the banks' efforts to fulfil their mandate makes it necessary to forge

anti-laundering regulations that can produce not only costs but also benefits for the banks.

Regulations must be drawn up to provide incentives for banks involved in the anti-laundering function, so that their conduct will be as effective as possible regarding that function, without reducing their efficiency in performing their normal duties.

Future legislation will certainly have to confirm and strengthen the approach taken in Law 153 of 1997, in which Parliament sought the collaboration of agencies and the authorities involved by rejecting a purely punitive approach. We fully concur with those who state that total observance of the anti-laundering laws cannot be imposed on the system from without through the use of coercive instruments. Rather, the law must insist on the strict adherence by intermediaries to the values of autonomy, integrity and legality.

In the future, the anti-money laundering laws must in no sense be considered an element extraneous to the general body of financial law, since this is a sector of regulation that participates in and contributes to the pursuit of the basic goals of transparency, propriety and prudence of business operation and the stability, competitiveness and proper functioning of the financial system.

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