

ANTI-MONEY LAUNDERING AND COUNTERING FINANCING OF TERRORISM REFORMS

PROPOSAL

1. I seek Cabinet's agreement to accelerate progress of the second phase of the anti-money laundering and countering financing of terrorism reforms, with a view to having reforms enacted by July 2017.
2. I also seek Cabinet's approval for additional funding to meet this accelerated time-frame.

EXECUTIVE SUMMARY

3. Money laundering is the process by which money obtained through crime is made legitimate or 'cleaned' to conceal its criminal origins. The financing of terrorism often uses similar methods as those used for money laundering. New Zealand's anti-money laundering and countering financing of terrorism (AML/CFT) regime aims to detect and support the recovery of these proceeds of crime so that criminals cannot enjoy the profits of their criminal activity, or reinvest it into further criminal conduct.
4. New Zealand's AML/CFT regime is organised around two phases of reform and is currently incomplete. Phase II of the reforms, which would extend AML/CFT obligations on lawyers, conveyancers, accountants, real estate agents and dealers in precious metals and jewels, are yet to be implemented.
5. These sectors, while not covered by AML/CFT regulation, pose a high risk for money laundering and terrorist financing. Recent Police investigations have also shown that professional services and real estate are often used to disguise the proceeds of organised crime and drug offending.¹ These domestic findings are in line with international research on AML/CFT risk sectors and are also reflected in the international obligations set by the Financial Action Task Force (FATF) - the international standard-setting and policy making body on combating money laundering and terrorist financing.
6. Since July 2015, the Ministry has undertaken work to assess the risk profile of the different Phase II sectors as have provided me with preliminary advice on scope and timing options. The Ministry of Justice advises that it could enact reforms within 24 months from project start. This time-frame is based on current Ministry of Justice capacity and the time required for the necessary policy work and parliamentary processes.

¹ In a Police study of 57 asset recovery cases, abuse of professional services were identified in 15 case (26%) relating to over NZD 137 million (62% of the assets in the sample). 46% of cases in the sample involved trusts, which were especially common in drugs cases. Companies structures were abused in 29% of fraud cases in the sample which accounted for 71% of assets in fraud cases.

7. However, I consider this time-frame puts New Zealand's criminal justice system and trade and international reputation at risk. While there are gaps in coverage vulnerabilities in New Zealand's criminal justice system remain and we lose opportunities to detect and disrupt both money laundering and the serious predicate offences such as drug offending, tax evasion, organised crime and terrorist financing that generate laundered funds. It is therefore important that the reforms be implemented as soon as possible to ensure New Zealand's financial systems and structures remain protected from domestic and transnational organised crime and terrorist groups.
8. Having a complete and operational AML/CFT regime by 2018 is also likely to result in a more favourable assessment during New Zealand's scheduled FATF assessment in 2019-2020. A critical assessment could negatively impact on New Zealand trade and international reputation.
9. To this end I propose the reforms be accelerated so that they are enacted by July 2017, with implementation to follow as soon as practically feasible. Accelerating reforms will require allocating s. 9(2)(f)(iv) to the Ministry of Justice and s. 9(2)(f)(iv) of Zealand Police. The Ministry and Police are currently at capacity delivering key Government priorities and cannot fund the acceleration of this project within current baselines.

BACKGROUND

10. New Zealand's AML/CFT regime is part of a suite of initiatives directed at combating transnational and organised crime.
11. Our regime is also informed by the international Recommendations set by FATF – an inter-governmental forum of technical experts on money laundering and countering terrorist financing. The FATF Recommendations specify the following types of businesses that fall within scope:
 - i. financial institutions that perform a wide range of financial services such as deposit-taking, lending, issuance of securities, portfolio management, and money and currency exchange etc.
 - ii. relevant non-financial entities, termed "Designated Non Financial Businesses and Professions" including casinos, lawyers, notaries, accountants, real estate agents, trust and company service providers, and dealers in precious jewels and metals.
12. New Zealand's AML/CFT work programme is organised around two phases of reform (Phase I and Phase II) [CAB (POL) MIN [08] 17/3 refers]. The Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (the Act), which came into force on 30 June 2013, implemented Phase I of the reforms and applied the AML/CFT regime to banks, casinos and financial institutions.
13. The institutions targeted in Phase I were assessed as carrying the highest risk of money laundering/terrorist financing. It was intended that other professions – real estate agents,

lawyers, accountants, conveyancers, bullion dealers, jewellers and precious metal dealers - would be brought under the Act through “Phase II” reforms at a later stage.

14. Since July 2015, the Ministry has undertaken work to assess the risk profile of the different Phase II sectors and have provided me with preliminary advice on scope and timing options. It has now become evident that this work needs to be progressed as a priority but cannot be adequately resourced within existing Ministry baselines. The proposal to seek additional funding in this paper has been held over pending the budget moratorium.

COMMENT

Current gaps in the AML/CFT regime pose material risk for New Zealand

15. Key sectors such as professional services providers, real estate and dealers in precious gems and metals, are currently not covered by the current AML/CFT framework. While these businesses have to comply with requirements under the Financial Transactions Reporting Act 1996, those obligations are not as robust as those under the AML/CFT Act. Therefore, these sectors already pose AML/CFT risks and continued non-coverage is increasing this risk.
16. In addition, the banking, securities, and trust and company service provider sectors (already covered by Phase I) have been somewhat critical of the fact that other sectors who are providing identical services are not yet required to comply with the legislation. The current market imbalance means there is a certain degree of competitive disadvantage for those reporting entities covered under Phase I.
17. Addressing these risks and market imbalances is necessary to enhance New Zealand’s criminal justice system as well as maintain New Zealand’s international and trade reputation.

Criminal Justice

18. The primary objective of the AML/CFT regime is to detect and deter money laundering and terrorism financing.
19. In New Zealand, a significant amount of crime involves organised criminal activity. For organised crime groups, profit tends to be the motivation, as is the case for fraud, tax evasion and corruption. The current AML/CFT regime seeks to “flush out” financial transactions related to the illegal proceeds of crime in order to detect crime and to prevent such funds from being reinvested in criminal conduct.
20. Current gaps in coverage are inhibiting law enforcement agencies’ ability to detect and deter organised crime and provide assistance to other jurisdictions to disrupt and break up international organised crime groups.
21. The sectors currently excluded from the regime are not explicitly required to know who their customers are and on whose behalf they act.
22. As a practical matter, this means that where Police has cause to investigate money laundering or organised crime, they are unable to “follow the money”. This is because the trail of information about the true source of that money ends with the sectors that are not covered.

23. The gap in coverage also means that these key sectors do not have the appropriate supervision and support to ensure that they are adequately assessing their customers' risk. In practice, this means that these sectors are vulnerable to unwittingly abetting money laundering and organised crime.

Trade and international reputation

24. Phase II would improve the integrity and stability of New Zealand's financial systems by expanding the transparency of financial transactions in New Zealand. This would give our international partners greater comfort when dealing with New Zealand businesses and ensures international trading opportunities remain open to New Zealand entities.

25. Coverage of the proposed Phase II entities is also a requirement of the international standards set by FATF and endorsed by over 180 jurisdictions including all of New Zealand's major trading partners.

26. New Zealand is due to be evaluated on its regime by FATF in 2019 – 2020. It is important that our AML/CFT regime is assessed as both technically compliant and effective. This is because New Zealand's AML/CFT regime – or any perceived gaps in it – directly affects New Zealand's international trade reputation.

27. A finding that New Zealand's AML/CFT systems are non-compliant could cause trade barriers for New Zealand as well as restricting legitimate overseas investment in New Zealand. This was demonstrated by the removal of New Zealand from the European Union's "white list" status in 2012.²

28. Internationally, there is a strong focus on preventing and disrupting terrorist financing and ensuring states have anti-money laundering and counter-terrorist financing regimes that are effective and credible. This is reflected in the focus taken on the issue at the Security Council, which recently passed Resolution 2253, requiring states to further strengthen their sanctions regimes. Strengthening our AML/CFT regime speedily supports New Zealand in this regard.

Phase II reforms will carry compliance costs

29. Phase II is complex and substantial policy project that will affect multiple government agencies and include significant consultation with professional bodies and the private sector. It will also require some structural reform of the current AML/CFT regime, which will carry costs for government.

30. The project will also require significant input from relevant agencies (including the Treasury, New Zealand Police, Ministry of Foreign Affairs and Trade, the Department of Internal Affairs, Reserve Bank of New Zealand, the Ministry of Business, Innovation and

² The "white list", abolished in 2015, specified non-EU countries that were considered to have equivalent AML/CFT systems as the EU. The Ministry received anecdotal information from the Financial Markets Authority (the statutory supervisor for the financial sector) that some businesses struggled to compete in EU markets or were refused opportunities in those markets following New Zealand's removal from the "white list".

Employment, the Financial Markets Authority, New Zealand Customs and Inland Revenue). This is likely to have direct impacts on the workloads and resource demands on these agencies.

31. As the reform will impose new compliance requirements, it will necessarily impose new compliance costs on Phase II sectors and / or their clients. Dealers in precious metals and jewels currently do not have any AML/CFT related obligations, and will likely face the highest compliance costs.
32. Lawyers, conveyancers, real estate agents and accountants are also likely to face some additional compliance burden and cost. While these sectors have had AML/CFT related obligations under the Financial Transactions Reporting Act, the more robust AML/CFT standards will impose further compliance requirements.
33. The costs of these reforms are currently unclear. While the Ministry commissioned Deloitte to carry out an assessment of business compliance costs in July 2008, this analysis was carried out before the introduction of Phase I and the AML regime has matured significantly since then. For these reasons, the information is out-of-date. Given the scale of proposed reform, I consider a further review of business compliance costs, as well as a cost-benefit analysis is necessary to ensure policy proposals are fit for purpose and proportionate.

Phase II reforms should be progressed as a matter of priority

34. I recommend that Phase II reforms be progressed as a matter of priority, with a view to having reforms enacted by July 2017.
35. My officials advise me that, based on current Ministry capacity, the project could be completed with 24 months from project start. This time-frame also takes into account the time required for the necessary policy work and parliamentary processes.
36. However I consider this timeframe poses risks for New Zealand. While there are gaps in coverage vulnerabilities in New Zealand's criminal justice system remain and we lose opportunities to detect and disrupt both money laundering and the serious predicate offences such as drug offending, tax evasion, organised crime and terrorist financing that generate laundered funds. Sectors will also continue to remain exposed to abuse by enterprising criminals, and also remain unsupported for a longer period of time.
37. A longer period of coverage gaps also increases the threat to New Zealand being targeted by international criminals and terrorists as a global "weak link" that can be exploited to inject the proceeds of crime into the international financial system.³
38. Finally, failing to implement the reforms by 2018 is likely to open New Zealand to criticism internationally, with potentially negative impacts on our trading ability. New Zealand is due

³ 60% of international requests for information to Police where a link to New Zealand was established related to a New Zealand company. In 75% of cases where a New Zealand company was identified, no New Zealand bank accounts were identified.

to be evaluated on its compliance with the FATF Recommendations in 2019 – 2020. The evaluation will primarily focus on operational effectiveness and not having a complete and fully functional regime for a sufficient period of time is likely to lead to a critical assessment.

39. A critical assessment could have a number of medium to long-term negative impacts both for the government as well as New Zealand businesses through:
- i. possible increased cost of borrowing overseas for both the government and private sector;
 - ii. difficulties (in the form of increased costs or lost business opportunities) for New Zealand companies in doing business overseas;
 - iii. overseas investment in New Zealand may be reduced because of investors' perception of increased risks, or legal restrictions in the investors' home jurisdictions.

Benefits of an accelerated time-frame

40. An accelerated time-frame would ensure we are able to promptly address the significant and increasing risk of non-AML/CFT regulated sectors being used as money laundering and terrorist financing channels. The earlier we are able to move to close gaps in the current regime, the faster law enforcement agencies' will be able to better detect and deter money laundering and terrorist financing, both domestically, as well as provide timely assistance to other jurisdictions to disrupt international organised crime and terrorist groups.
41. In addition to law enforcement agencies, closing the current gaps would enable the professional services sectors, regulatory agencies and reporting entities to better detect, deter and prevent money laundering, associated predicate offending (such as tax evasion, corruption and fraud and terrorist financing).
42. Having a complete and fully functional AML/CFT regime operating from 2018 is most likely to result in a positive FATF evaluation, thereby avoiding negative impacts on New Zealand's economy and trade reputation. The evaluation will primarily focus on the effectiveness of New Zealand's AML/CFT regime so it will be important that we have a complete and operational regime for a length of time before the assessment.

Risks

43. There is a risk that such a large piece of regulation carried out within 12 months might make technical errors or fail to identify key issues. I consider this risk can be mitigated to an extent by engaging input from all other relevant agencies (both policy and operations-focussed) such as the Department of the Prime Minister and Cabinet, New Zealand Police, Department of Internal Affairs, the Financial Markets Authority, the Reserve Bank of New Zealand, the Ministry of Business, Innovation and Employment, New Zealand Customs Service and the Treasury from the earliest stages of policy development.

44. I further propose to mitigate this risk by directing the Ministry to adopt a more inclusive approach working in partnership with relevant private sector bodies, including through constituting expert reference groups, throughout the Phase II policy development process. The benefit of this approach is that reforms would be more likely to be proportionate, implement “real world” solutions that take into account business realities to the greatest extent possible; and secure some “buy in” from affected sectors.
45. PCO may be unable to meet truncated time-frames for drafting the necessary legislation. To mitigate this risk, I propose to direct the Ministry to provide as much time as possible, but at least three months to PCO for drafting. The current PCO guidelines suggest six months for a project this size. In addition, I propose that the Ministry retain close contact with PCO during the policy development stage so that PCO is well prepared to draft policy proposals as they are finalised.
46. Progressing the reforms this quickly also raises the risk that substantive policy proposals are opposed by sectors during the Parliamentary progress of the Bill. I propose to mitigate this risk by seeking input from relevant private sector bodies throughout the Phase II policy development process, as noted in paragraph 44 above.
47. While increased compliance requirements may be met with resistance from individual professionals, some sector regulators and representative bodies have noted their support for reform – the New Zealand Law Society, the Real estate Institute of New Zealand and the Real Estate Agents Authority have noted that the reforms would provide greater certainty to their members, and reduce the AML/CFT risk attaching to these sectors.

FINANCIAL IMPLICATIONS

Accelerating Phase II reforms will require additional funding

48. The Ministry is currently at capacity and cannot deliver this work on a truncated time-frame within baseline. It will require additional policy funding to resource this project if a decision to accelerate phase II reforms is made. If the Ministry had to resource this work within current baseline without this additional funding, it would significantly delay the Ministry’s delivery on key Ministerial and/or Government priorities.
49. I therefore seek additional funding from between-Budget operating contingency. The additional funding would be appropriated to Vote Justice.
50. To meet the truncated time-frame, funding is required to employ additional senior level staff with technical expertise on AML/CFT issues. The Ministry will also need to fund a more intensive consultative approach during policy development so that it is able to secure as much support for reform as possible from sectors within an extremely short time-frame.
51. Given the significant input the Ministry will require from relevant key agencies such as Police and the current supervisory agencies, I also seek funding for relevant agencies when providing significant contributions to Phase II policy development that cannot be met within those agencies’ baselines, for example, through employing additional staff dedicated

to the Phase II reform project. These funds would be held within the Vote Justice appropriation and disbursed to the requesting agency as appropriate.

52. As noted in paragraph 35, given the scale of reform it is important to ensure reform is proportionate to compliance burdens imposed on sectors. I therefore recommend Cabinet approve funding, as part of policy development, for a study of estimated business compliance costs for Phase II sectors and an analysis of costs and benefits of reform.

53. A preliminary assessment of costs for a truncated time-frame is set out below:

| Project component | Costs |
|---|-------|
| Withheld under section 9(2)(f)(iv) of the OIA | |

Additional Police policy funding

54. Police currently have a budget appropriation under Vote Police for giving effect to AML/CFT legislation; however this is for additional operational staff to give effect to changes to reporting amendments under the AML/CFT Act enacted last year.

55. The Phase II reforms will be heavily evidenced and supported by Police data, research and statistics. Police note that it is currently at capacity and would require additional funding to provide this support. The additional policy funding would be required to fund primary research, gathering evidence which will include analysing cases. There is also likely to be significant work liaising with the sectors that will be affected by this change.

56. Police, therefore, seek a separate appropriation from the between-Budget operating contingency under Vote Police

Next steps

57. If Cabinet agrees to a truncated time-frame and additional funding, I intend to submit policy proposals for Cabinet's consideration as soon as practicable with a view to having a Bill introduced before the end of the year. If that is not possible it may be necessary to truncate the legislative process.
58. As part of the policy approval, I anticipate seeking Cabinet's agreement to the sectors that should be covered under Phase II, the preferred supervisory model to monitor and enforce compliance of AML/CFT obligations, and other ancillary matters.

Consultation

59. The Department of Internal Affairs, the Financial Markets Authority, the Reserve Bank of New Zealand (AML/CFT supervisors), New Zealand Police, the New Zealand Customs Service, the Ministry of Foreign Affairs and Trade and The Treasury have been consulted on this proposal. The Department of the Prime Minister and Cabinet has been informed.

Human Rights

60. The reforms are not expected to raise issues with the issues with the New Zealand Bill of Rights Act 1990.

Legislative Implications

61. A Bill will be required to implement the reforms. Currently, the Legislation programme does not include an Anti-money Laundering and Countering the Financing of Terrorism Amendment Bill.

Regulatory Impact Analysis

62. A Regulatory Impact Analysis Statement will be prepared during the policy development process.

Gender Implications

63. The reforms will not have any gender implications.

Disability Perspective

64. The reforms will not have any disability implications.

Publicity

65. If Cabinet agrees to a truncated time-frame and additional funding, my office will coordinate communications on Phase II reforms.

Treasury Comment

66. Due to the short consultation period on this paper Treasury has not had the opportunity to explore other funding options for this proposal with the Ministry of Justice, including funding from baselines. The Ministry should outline to Ministers what lower priority activities would need to be stopped if this proposal was to be carried out without additional funding.

Recommendations

67. The Minister for Justice recommends that the Committee:

1. **Note** that in September 2008, the Government agreed that the AML/CFT reforms would apply in a first phase to financial institutions and the casino sector (collectively referred to as reporting entities) and in a second phase, to non-financial businesses and professions with the types of organisations and the nature of their obligations for inclusion in the provisions to be subject to further policy development [Cab Min (08) 36/3 refers];
2. **Note** that the Anti-Money laundering and Countering Financing of Terrorism Act 2009 implemented the first phase of reform;
3. **Note** that the Ministry of Justice's proposed time-frame of having the second phase of reforms enacted 24 months from project start date poses material risks for New Zealand;
4. **Agree** to progress the second phase of anti-money laundering and countering financing of terrorism reforms, with a view of having reforms enacted by July 2017
5. **Approve** the following changes to appropriations to give effect to the policy decision in recommendation 4 above, with a corresponding impact on the operating balance:

| | \$m – increase/(decrease) | | | | |
|---|---------------------------|---------|---------|---------|-----------------------|
| Vote Justice Minister of Justice | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 & Outyears |
| withheld under section 9(2)(f)(iv) of the OIA | | | | | |
| | | | | | - |
| Vote Police Minister of Police | | | | | |
| withheld under section 9(2)(f)(iv) of the OIA | | | | | |

6. **Agree** that the proposed change to appropriations for 2016/17 above be included in the 2016/2017 Supplementary Estimates and that, in the interim, the increase be met from Imprest Supply;
7. **Agree** that the expenses incurred under recommendation 5 above be a charge against the between-Budget operating contingency, established as part of Budget 2016.

Hon Amy Adams
Minister for Justice