On the Performance-based Legitimacy of FATF[1]

A Quantitative Exploration

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Introduction

- Money Laundering (ML) - **never a victimless crime**
  - UNODC[2] estimates that between 2 and 5% of global GDP is laundered each year, or $800 billion - $2 trillion.
  - ML is deeply related to terrorism financing, drug smuggling, human trafficking, corruption, extortion, ...
- Financial Action Task Force (FATF) - **global financial guardian**
  - Established in 1989 by the G7, FATF is an intergovernmental organization dedicated to anti-money laundering (AML) for over three decades, with over 200 jurisdictions joining its network.
  - Yet, FATF still faces criticism for perceived discrimination (Littrell 2022), political manipulation (Chohan 2019; Case-Ruchala and Nance 2020), and lack of credibility in its evaluations (Levi, Reuter, and Halliday 2018; Pontes et al. 2022).

[2] The United Nations Office on Drugs and Crime: https://www.unodc.org/roca/en/NEWS/news_2024/november/improving-regional-investigations-on-money-laundering-and-asset-recovery.html

Key Questions

Key Question 1

- **Has FATF's governance improved regional compliance?**
  - Existing research (Verdugo Yepes 2011; Mekpor, Aboagye, and Welbeck 2018) only focuses on *regional characteristics* as determinants of compliance, yet ignores the impact from FATF's governance.
  - Identifying FATF-induced compliance is crucial for assessing its strategy legitimacy, which is also corroborated by Mitchell's compliance theory (Mitchell 1993, 2001, 2008, 2014, 2021).

Key Question 2

- **Can compliance with FATF's Recommendations efficiently convert into effectiveness?**
  - Conversion efficiency into effectiveness matters besides the compliance, which is already high on average (60% during 4th-round initial evaluations).
  - Effectiveness measurements from both FATF and external sources should be considered and compared carefully.

Key Question 3

- **How do regional capacities affect conversion efficiency, and has FATF addressed the gap (if any) properly?**
  - Incapacities, as important sources for non-compliance suggested in Mitchell's compliance theory (Mitchell 1993, 2001, 2008, 2014, 2021), might also significantly *impede conversion into effectiveness*. **This is uniquely argued in our study.**
  - Suitable strategies *differ greatly for states with different causes* (e.g., incapacities, ideological differences, costs-benefits trade-off) for poor performance.

Data

Data

Primary Dataset

- **Mutual Evaluations Ratings**
  - We focus on FATF's **4th-round** mutual evaluations ratings from 2014 January to 2025 July, covering 194 jurisdictions.
  - Categorical ratings consistent of two components:
    1. Technical compliance ratings for 40 FATF's Recommendations
    2. Effectiveness ratings for 11 FATF's Immediate Outcomes (Goals)
  - We encode 4 categorical levels from lowest to highest into a range from 0 (null compliance / effectiveness) to 1 (full compliance / effectiveness) and construct indices for **quantitative analysis**.

Data

FATF Indices by Continent

Technical Compliance Index (TCI)	Global	Europe	Asia	North America	Oceania	Africa	South America
A: Policy and Coordination	0.56	0.64	0.60	0.61	0.49	0.39	0.71
B: ML and Confiscation	0.71	0.78	0.69	0.77	0.65	0.61	0.75
C: Terrorist Financing	0.43	0.53	0.47	0.50	0.43	0.25	0.43
D: Preventive Measures	0.62	0.67	0.67	0.68	0.55	0.50	0.65
E: Transparency and Beneficiary	0.39	0.52	0.40	0.42	0.33	0.25	0.43
F: Authorities and Others	0.62	0.67	0.65	0.65	0.56	0.52	0.71
G: International Cooperation	0.65	0.73	0.64	0.67	0.57	0.58	0.69
Individual Average (I-TCI)	0.60	0.66	0.63	0.64	0.53	0.48	0.65
Sectional Average (S-TCI)	0.57	0.65	0.59	0.62	0.51	0.44	0.62

Notes: the table summarizes the different variations of technical compliance indices (sectional, individual-average, section-average) from the FATF fourth-round initial evaluations by continent.

Effectiveness Index (EI)	Global	Europe	Asia	North America	Oceania	Africa	South America
A: Risk Mitigation	0.40	0.57	0.47	0.41	0.43	0.11	0.46
B: Crime Proceeds Prevention	0.22	0.34	0.26	0.24	0.21	0.04	0.25
C: Threat Detection	0.26	0.41	0.32	0.28	0.20	0.07	0.28
Individual Average (I-EI)	0.28	0.42	0.33	0.29	0.25	0.07	0.30
Sectional Average (S-EI)	0.29	0.44	0.35	0.31	0.28	0.07	0.33

Notes: the table summarizes the different variations of effectiveness indices (sectional, individual-average, section-average) from the FATF fourth-round initial evaluations by continent.

- **Regional Characteristics Data**
  - Worldwide Governance Indicators (WGI), internet access, education, foreign investment data from World Bank
  - Financial Development Indices (FDI) from International Monetary Fund
  - Human Development Index (HDI) from United Nations Development Program
- **External Effectiveness Measurements**
  - Basel AML Index from Basel Institute on Governance
  - We construct Basel (non-FATF) Effectiveness Indices from the raw Basel AML indicators.

Theory

- **Mitchell's Compliance Theory** (Mitchell 1993, 2001, 2008, 2014, 2021)
  - There is *no sufficient theory* analyzing financial governance, especially in the context of money laundering (Chong and Lopez-De-Silanes 2015; Woo et al. 2016; Brooks et al. 2019; Jones and Knaack 2019; Abedin et al. 2024).
  - We build upon Mitchell's compliance theory, originally discussed in binding international environmental laws and agreements (IEL/IEA), by extending it to non-binding institutions such as FATF and enriching the discussion on **effectiveness**.
  - Jurisdiction-level compliance and effectiveness data fit seemlessly in this framework and is adequate to test relevant propositions and extentions.

- **Performance as Source for Legitimacy**
  - Legitimacy beliefs, widely recognized as stemming from international organizations' (IO) purpose, procedure, and performance (3P) (Scharpf 1999; Scott et al. 2005; Hurd 2008; Bernauer and Gampfer 2013; Binder and Heupel 2015; Lenz and Viola 2017; Scholte, Tallberg, et al. 2018; Tallberg, Bäckstrand, and Scholte 2018; Dellmuth, Scholte, and Tallberg 2019; Tallberg and Zürn 2019), can be *validly proxied by these elements*.
  - Jurisdiction-level compliance and effectiveness data can capture FATF's governance performance from the perspectives of *standards, evaluation, strategy*.[3]

[3] Criteria for performance-based legitimacy are detailed in the paper.

FATF-induced Compliance

FATF-induced Compliance

Follow-up Procedures

- The treatment of **enhanced follow-up** (EFU) or **regular follow-up** (RFU, default) is directly determined by the compliance and effectiveness ratings on the 4th-round initial evaluations.[4]
- EFU requires *higher intensity* of supervision than RFU. Only around 14.43% of jurisdictions remain in the RFU, as of 2025 July.

Counts	Global	Europe	Asia	North America	Oceania	Africa	South America
States with MER available	194	49	43	30	12	48	12
States in Regular Follow-up	28	15	8	4	1	0	0
States in Enhanced Follow-up	166	34	35	26	11	48	12
Pass Rate	14.43%	30.61%	18.60%	13.33%	8.33%	0.00%	0.00%

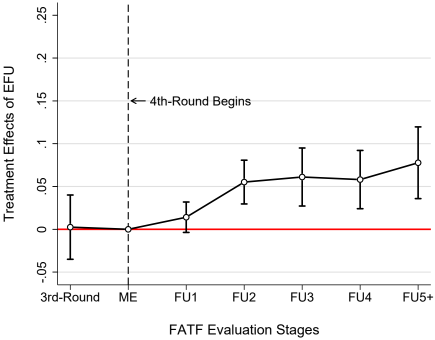
Notes: the table summarizes the FATF fourth-round follow-up statistics by continent. The first row shows the number of states that completed the initial evaluation (with mutual evaluation reports (MER) available). The second row shows the number of states that entered the default regular follow-up, and the third row shows that of enhanced follow-up. *Pass rate* is the proportion of states that passed the regular follow-up criteria.

[4] Criteria regarding the follow-up procedures are detailed in the paper or see in https://www.fatf-gafi.org/en/publications/mutualevaluations/documents/4th-round-procedures.html

FATF-induced Compliance

Enhanced Follow-up Shines

- Simple Differences-in-difference (DID) model estimates a treatment effect of 4.13% from 4th-round EFU relative to RFU.
- EFU **boosts compliance** with *gains intensifying* over follow-up evaluation stages.
- Improvement from EFU rises from 1.41% in the 1st follow-up to 7.77% in the 5th or later follow-up.

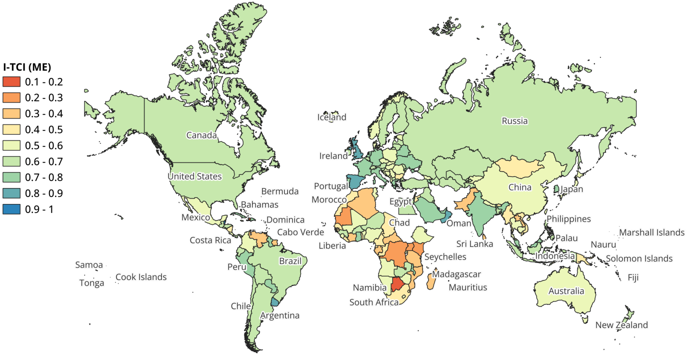


Compliance→effectiveness Conversion

FATF Compliance→effectiveness Conversion

Compliance World Map

FATF 4th-Round Mutual Evaluation (ME)
Individual-Average Technical Compliance Index (I-TCI)

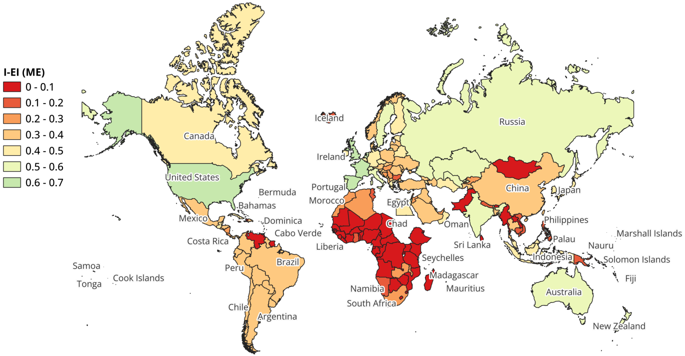


Source data from FATF official portal: https://www.fatf-gafi.org/en/publications/Mutualevaluations/Assessment-ratings.html
Index and map created by Guo Cheng (2025)

FATF Compliance→effectiveness Conversion

Effectiveness World Map

FATF 4th-Round Mutual Evaluation (ME) Individual-Average Effectiveness Index (I-EI)



Source data from FATF official portal: https://www.fatf-gafi.org/en/publications/Mutualevaluations/Assessment-ratings.html
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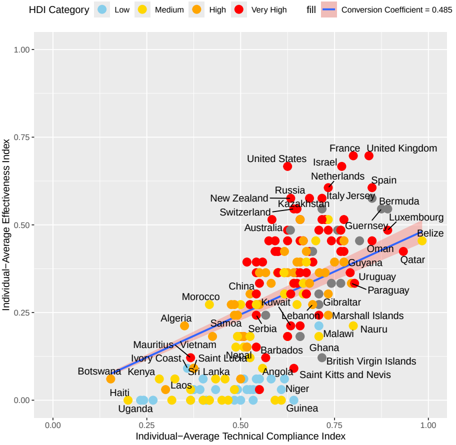
FATF Compliance→effectiveness Conversion

Scatter Plot

- **Average** conversion coefficient worldwide is 48.5%.[a]
- Conversion efficiency *differs significantly among regions*.
- **Capacities** mediate the conversion: in general, regions with higher HDI lie above the regression line while lower-HDI counterparts lie below the average.[b]



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[a] Assume zero-intercept regression, i.e., if no compliance, a jurisdiction is expected to have null effectiveness under FATF effectiveness framework. The calculation includes jurisdictions with human development index (HDI, 2022 Edition) available.

[b] Gray dots on the scatter plot are jurisdictions with no available HDI (2022 Edition).

FATF Compliance→effectiveness Conversion

Mediation Regression (HDI)

- With mediation from HDI, the regression *R-squared increases significantly.*
- Very-high-HDI jurisdictions (61.3%) are **7.75** times more efficient than low-HDI counterparts (7.91%)!

	OLS		
	(1) No Mediation	(2) Mediation: HDI value	(3) Mediation: HDI 4 Categories
TCI	0.485***		
	(0.0181)		
$HDI \times TCI$		0.653***	
		(0.0178)	
$HDI_{LOW} \times TCI$			0.0791***
			(0.0195)
$HDI_{MEDIUM} \times TCI$			0.345***
			(0.0387)
$HDI_{HIGH} \times TCI$			0.512***
			(0.0197)
$HDI_{VERYHIGH} \times TCI$			0.613***
			(0.0227)
No. of Observations	178	178	178
R^2	0.802	0.882	0.898

Notes: The dependent variable is Individual-Average Effectiveness Index, and independent variable is Individual-Average Technical Compliance Index. The relationship is mediated by Human Development Index (HDI), ranging from 0 to 1. We consider continuous HDI and HDI categories (Low, Medium, High, Very High) defined by United Nations. Robust standard errors are used. Zero-intercept is assumed. * 0.1 ** 0.05 *** 0.01

FATF Compliance→effectiveness Conversion

Mediation Regression (Nuanced Capacities)

- Administrative, technological and certain financial factors all play significant roles in mediation.
- In particular, **technological** and **financial** capacities are *more important* in mediation compared with regulatory quality.

	OLS		
	(1) Admin, Tech, and Fin (1)	(2) Admin, Tech, and Fin (2)	(3) Admin, Tech, and Fin (3)
Regulatory Quality × TCI	0.239* (0.142)	0.186 (0.178)	0.165 (0.189)
Access to Internet (% of Population) × TCI	0.285** (0.121)	0.283** (0.119)	0.240** (0.115)
Financial Development × TCI	0.406*** (0.0841)		
Financial Institutions Development × TCI		0.292 (0.178)	
Financial Markets Development × TCI		0.172* (0.0893)	
Financial Institutions Access × TCI			0.151* (0.0793)
Financial Institutions Depth × TCI			0.0500 (0.126)
Financial Institutions Efficiency × TCI			0.161 (0.102)
Financial Markets Access × TCI			0.129 (0.0778)
Financial Markets Depth × TCI			-0.149 (0.130)
Financial Markets Efficiency × TCI			0.268*** (0.0649)
No. of Observations	108	108	108
R^2	0.918	0.919	0.928

Notes: The dependent variable is Individual-Average Effectiveness Index, and independent variable is Individual-Average Technical Compliance Index. The relationship is mediated by regional factors spanning administrative, technological, and different layers of financial factors. Robust standard errors are used. Zero-intercept is assumed. * 0.1 ** 0.05 *** 0.01

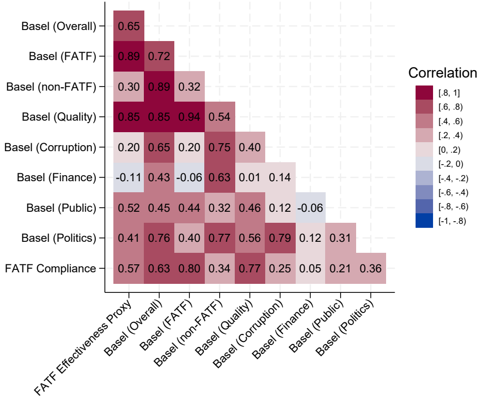
Conversion to Basel non-FATF Effectiveness

- Capacity-mediation mechanism **remains robust**: very-high-HDI regions (7.49%) are still more efficient than other groups (slightly negative). [5]
- Yet, the conversion coefficients are NOT significant in all specifications with two-way fixed effects.
- **This finding casts doubt on efficacy of FATF recommendations (in terms of external Basel non-FATF effectiveness) and reliability of FATF effectiveness ratings.**

[5] Models here adopt panel analysis with two-way fixed effects which are more robust than the cross-sectional (FATF effectiveness ratings are only available during initial evaluations) analysis with zero-intercept for FATF effectiveness conversion.

Correlations Between FATF and Basel Effectiveness[6]

- Overall correlation is high at 0.65 because of the inclusion of FATF ratings in Basel index methodology (domain of AML framework quality).
- Correlation with Basel **non-FATF** effectiveness is only 0.30.
- Correlations with **corruption & fraud control** (0.20) and **financial transparency** (-0.11) are most concerning.



[6] Basel AML risks indicators (Expert Edition Plus, 2025 March Version) are used to construct the Basel effectiveness indices. FATF compliance ratings are as of 2025 July, while FATF effectiveness ratings come from 4th-round initial evaluations.

Institutional Reflections

Institutional Reflections

- **Standards & Evaluation**
  - FATF's Recommendations need refinement to be more effective **on average** (especially regarding external measurements).
  - Ideally, the feasibility and efficacy of standards should remain robust to *capacity levels* so that they do not pose additional challenges to **developing states**.[7]
  - Internal effectiveness ratings should be comprehensive without overrelying on compliance results. Cross-validation with external proxies is necessary to ensure evaluation robustness.

[7] This might be too idealistic and impractical, yet incentive-based strategies can compenstate.

Institutional Reflections

- **Strategy**
  - Punitive or supervisory strategies (e.g., enhanced follow-up) work to raise compliance.
  - However, one-size-fits-all punishment is detrimental to good-faith yet developing regions with poor performance, since innocent incapacities hinder both <u>compliance</u> and <u>effectiveness conversion</u>.
  - **Common But Differentiated Responsibilities (CBDR)**
    - Transitory poor performance of low-capacity states are <u>understandable</u>.
    - It is also <u>accepatable</u> for now, since these regions play a less significant role (smaller responsibility required) in the global system.
    - <u>Incentive-based</u> aids, either ex ante (provide assistance in advance) or ex post (offer rewards after progress), are beneficial.

Future Outlook

- **FATF's Shift - Financial Inclusion**
  - Remarkably, since the presidency of Elisa de Anda Madrazo of Mexico in July 2024, FATF has prioritized advancing financial inclusion to support low-capacity states.
  - President De Anda emphasizes cognitive (develop guidance on AML effectiveness in the low-capacity context) and generative (unit an alliance of technical assistance providers) approaches.
  - This shift is *sufficiently justified by our theory and empirical evidence*.
  - **The 5th-round of FATF mutual evaluations has begun since 2024. How will FATF move forward the global AML cause ...? Let us see!**

Future Outlook

Theory

- **Compliance Theory Framework**
  - We demonstrate the unversality of Mitchell's compliance theory beyond analyzing binding IEL/IEA to institutions of any level of formality, such as FATF (non-binding, lower formality).
  - This framework and extensions we propose can be readily applied to *other fields of regulation and governance*.
- **Objective, Quantitative Inferences for Legitimacy**
  - We propose a quantitative inference scheme for the performance-based IO legitimacy based on objective, official data.
  - This type of approach complements, rather than challenges or surpasses, mainstream methods such as qualitative normative comparisons and subjective belief surveys.

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