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PAPER-FUNCTIONAL COMPLIANCE AND ANTI-MONEY LAUNDERING AND COUNTER FINANCING OF TERRORISM EFFECTIVENESS: EVIDENCE FROM NIGERIA

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ABSTRACT

This paper develops and applies the concept of paper-functional compliance to explain why strong formal alignment with Financial Action Task Force (FATF) anti-money laundering and counter-terrorism financing (AML and CFT) standards often fails to translate into effective enforcement outcomes in developing and high-informality states, using Nigeria as an empirical case. Drawing on an exploratory qualitative research design, the study triangulates evidence from thirty-six semi-structured interviews with regulators, law-enforcement and security agencies, financial institutions, designated non-financial businesses and professions (DNFBPs), and policy experts; two focus group discussions; and documentary analysis of FATF and Inter-Governmental Action Group against Money Laundering in West Africa (GIABA) mutual evaluation reports, national risk assessments and AML and CFT legislation. The findings show that Nigeria shows strong paper compliance through extensive legislation, institutional frameworks, and regulatory guidance, driven by external pressure, reputational incentives and the demands of global financial integration. However, these formal reforms have not produced commensurate functional compliance. Effective enforcement remains weak due to entrenched informality, fragmented identity and beneficial ownership systems, limited investigative and prosecutorial capacity, weak supervision of DNFBPs, inter-agency fragmentation, political interference and persistent insecurity across large territorial spaces. These structural constraints systematically undermine the conversion of formal compliance into operational effectiveness. While the qualitative, single-country design limits statistical generalizability and some enforcement claims could not be independently verified due to data sensitivity, the study proves the analytical value of theory-building qualitative research in uncovering compliance mechanisms obscured by formal metrics. By introducing paper-functional compliance as a novel analytical framework, the paper offers transferable insights for understanding FATF implementation gaps and for designing more context-sensitive AML and CFT reforms in developing and fragile jurisdiction.

KEYWORDS: Anti-Money Laundering; Counter-Terrorism Financing; Paper-Functional Compliance; FATF Effectiveness; Regulatory Implementation and Nigeria.

1. INTRODUCTION

The global AML and CFT regime are anchored on the international standards developed by the FATF. Over the past three decades, FATF Recommendations have become the dominant framework shaping national AML and CFT laws, regulatory institutions and supervisory practices worldwide. Countries are evaluated through dual architecture that distinguishes between technical compliance assessing the formal alignment of laws and institutions with FATF international standards and effectiveness, measured through Immediate Outcomes¹ that capture real-world enforcement performance.

Furthermore, in principle, strong technical compliance should support effective AML and CFT outcomes. In practice, however, evidence from many developing and high-informality economies reveals a persistent and troubling pattern: extensive legislative and institutional reforms coexist with weak investigations, limited prosecutions, minimal asset recovery and ineffective disruption of terrorist financing. Nigeria exemplifies this paradox. Despite substantial improvements in technical alignment reflected in its 2021 mutual evaluation, effectiveness ratings across several Immediate Outcomes remain modest or low, indicating limited operational impact (FATF, 2023). While this divergence between formal adoption and practical enforcement is widely acknowledged in policy circles, it remains under-theorised in the academic literature (Reuter & Truman, 2004; Levi & Reuter, 2006; de Koker, 2024).

¹ The FATF effectiveness framework comprises eleven Immediate Outcomes (IOs) that define the results an effective AML and CFT system should achieve in practice. **IO.1 (Risk, Policy and Coordination)** assesses whether countries understand their money laundering and terrorism financing risks and apply coordinated, risk-based policies to mitigate them. **IO.2 (International Cooperation)** examines the extent to which competent authorities provide timely, constructive, and effective international cooperation. **IO.3 (Supervision)** evaluates whether supervisors appropriately supervise, monitor, and regulate financial institutions and designated non-financial businesses and professions for compliance with AML and CFT requirements. **IO.4 (Preventive Measures)** focuses on whether financial institutions and DNFBPs adequately apply customer due diligence, record-keeping, and suspicious transaction reporting measures. **IO.5 (Legal Persons and Arrangements)** assesses the transparency and availability of beneficial ownership information and the effectiveness of measures preventing the misuse of legal persons and arrangements. **IO.6 (Financial Intelligence)** evaluates whether financial intelligence and related information are properly collected, analysed, and disseminated to support operational needs. **IO.7 (Money Laundering Investigation and Prosecution)** examines whether money laundering offences and activities are investigated and offenders are prosecuted and sanctioned effectively. **IO.8 (Confiscation)** assesses the extent to which proceeds and instrumentalities of crime are confiscated in

Existing studies document weak enforcement, corruption, informality, and capacity constraints but stop short of explaining *why* strong paper alignment so often fails to produce functional results. FATF's own analytical distinction between technical compliance and effectiveness identifies the gap but does not provide a theoretical account of the structural mechanisms that sustain it.

This paper addresses that gap by introducing the concept of *paper-functional compliance*. Paper compliance refers to the formal adoption of AML and CFT laws, institutions and regulatory frameworks that satisfy international standards and are readily demonstrable in mutual evaluations. Functional compliance, by contrast, denotes the extent to which these formal arrangements generate effective enforcement outcomes, including credible investigations, prosecutions, asset confiscation, terrorism financing disruption and meaningful supervision of high-risk non-financial sectors. The distinction is analytically important because it explains how jurisdictions can perform well on technical metrics while remaining ineffective in practice.

Using Nigeria² as an empirical case, the study draws on qualitative evidence from thirty-six elite interviews, two focus group discussions, and documentary analysis of mutual evaluation reports, national risk assessments, and AML and CFT legislation. The findings demonstrate that Nigeria's strong paper compliance is driven largely by external pressures, reputational incentives and the relatively

line with identified money laundering and terrorism financing risks. **IO.9 (Terrorism Financing Investigation and Prosecution)** focuses on whether terrorism financing offences are investigated and prosecuted effectively. **IO.10 (Terrorism Financing Preventive Measures and Financial Sanctions)** evaluates the implementation of targeted financial sanctions and other measures to prevent the misuse of the financial system for terrorism financing. **IO.11 (Proliferation Financing)** assesses the effectiveness of targeted financial sanctions and other measures related to combating the financing of the proliferation of weapons of mass destruction.

² Nigeria is an appropriate and analytically rich case study for examining the effectiveness of FATF AML and CFT international standards because it embodies the core tensions that the global AML and CFT regime seeks to address, particularly the gap between formal compliance and practical effectiveness. As Africa's largest economy and most populous country, Nigeria occupies a strategic position within the international financial system while simultaneously exhibiting high exposure to money laundering and terrorism financing risks linked to corruption, organised crime, insurgency, and a large informal economy. Nigeria has formally adopted almost all FATF Recommendations and has undergone multiple Mutual Evaluations under GIABA, making it a paradigmatic example of a jurisdiction that demonstrates strong legislative and institutional alignment with international standards.

low political cost of legislative reform. Conversely, functional compliance is constrained by deep-seated structural factors, including informality, fragmented identity and beneficial ownership systems, limited investigative capacity, weak DNFBP supervision, inter-agency fragmentation, political interference, and insecurity in contested territories.

The paper makes three contributions. First, it offers a theory-informed framework that explains the persistent divergence between FATF technical compliance and effectiveness outcomes by identifying the structural conditions that mediate implementation. Second, it extends compliance theory by introducing *structural feasibility* as a necessary dimension of compliance analysis, alongside deterrence, normative alignment and capacity. Third, it refines liberal institutionalist accounts of global governance by demonstrating that the influence of international standards is context-bounded and uneven across institutional domains. Beyond Nigeria, the paper-functional compliance framework offers transferable insights for understanding AML and CFT implementation challenges in other developing and fragile states.

This paper is structured into seven (7) sections. This introduction is followed by Section 2 which develops the conceptual and theoretical foundations of paper-functional compliance; Section 3 outlines the methodology; Section 4 presents empirical evidence of Nigeria's compliance gap; Section 5 elaborates the conceptual implications; Section 6 discusses theoretical and policy implications; and Section 7 concludes the paper.

2. LITERATURE REVIEW

The concept of paper versus functional compliance captures a foundational tension in global AML and CFT governance, namely, the gap between the formal adoption of regulatory standards and the actual ability of countries and jurisdictions to operationalize them. While FATF has developed an elaborate framework for assessing compliance, most scholarly and policy analyses focus on the presence of formal rules rather than on their practical enforcement. This section situates the concept into existing debates on compliance, state capacity, global governance, and the effectiveness of international financial regulation.

2.1. Evolution Of Financial Action Task Force

The FATF was established in 1989 by the G7 in response to growing concerns about the use of the global financial system to launder proceeds of drug trafficking and organized crime. Its original mandate

focused narrowly on money laundering, culminating in the issuance of the first set of 40 Recommendations in 1990. These Recommendations provided a harmonized regulatory template for national AML regimes, emphasizing criminalization, preventive measures in the banking sector, and international cooperation. From its inception, FATF functioned not as a treaty-based organization but as a soft-law standard setter, relying on peer pressure, reputational incentives, and market discipline rather than formal legal coercion (Reuter & Truman, 2004; Sharman, 2011).

Furthermore, following the terrorist attacks of 11 September 2001, FATF's mandate expanded significantly to include CFT marked by the adoption of the Eight (later Nine) Special Recommendations on Terrorist Financing. This expansion entrenched FATF as the central node of the global AML and CFT regime and accelerated the diffusion of its standards across developed and developing economies alike. The scope of compliance widened beyond banks to encompass DNFBPs, non-profit organizations, and cross-border financial flows. However, this rapid expansion also intensified the regulatory burden on states with limited institutional capacity, reinforcing concerns that formal adoption often outpaced practical enforcement (Naylor, 2002; Levi & Reuter, 2006).

Moreover, a critical turning point in FATF's evolution occurred with the introduction of the Mutual Evaluation process and the increasing use of public listings (blacklists and grey lists) to discipline non-compliant authorities. Mutual Evaluation Reports (MERs) became the principal mechanism through which FATF, and its regional bodies assessed countries, initially focusing on technical compliance with Recommendations. This assessment of architecture incentivized states to prioritize legislative enactment and institutional creation, as these were more readily demonstrable and politically less costly than deep structural reforms. Scholars have noted that this dynamic fostered a form of symbolic or ceremonial compliance, particularly in developing countries seeking to avoid reputational damage or exclusion from correspondent banking networks (Sharman, 2011; De Koker & Jentzsch, 2013).

In response to growing criticism that formal compliance did not translate into meaningful reductions in money laundering or terrorism financing, FATF revised its standards in 2012 and introduced an effectiveness-oriented methodology centred on eleven Immediate Outcomes (IO). This marked a conceptual shift from rule adoption to

practical results, such as successful investigations, prosecutions, asset confiscation, and risk mitigation. While this reform aimed to correct the “checklist” bias of earlier evaluations, empirical evidence suggests that effectiveness assessments remain constrained by structural inequalities, data limitations, and uneven enforcement capacity, particularly in cash-based and informal economies (FATF, 2013; Halliday, Levi, & Reuter, 2014).

The evolution of FATF thus reflects an unresolved tension between global standardization and domestic implementation realities. While the framework has become increasingly sophisticated and outcome-oriented, its reliance on soft-law mechanisms continues to privilege visible, documentable reforms over deeper functional transformation. This trajectory is central to understanding the persistence of paper compliance without corresponding functional compliance in many jurisdictions. In this sense, FATF’s evolution has not eliminated compliance gaps but has instead reshaped them, making the distinction between formal adherence and practical effectiveness a defining feature of contemporary AML and CTF governance (Halliday & Carruthers, 2007; Sharman, 2011).

2.1.1. Technical Vs Effective Compliance: Financial Action Task Force’s Distinction

FATF’s evaluation architecture is built on a dual structure of Technical Compliance (TC), which assesses whether a jurisdiction’s legal and institutional framework conforms to the 40 Recommendations and Effectiveness, measured through the eleven IOs, which evaluate whether AML and CTF systems produce demonstrable results such as successful prosecutions, confiscation of proceeds of crime, and disruption of terrorist financing networks (FATF, 2013).

Although this distinction acknowledges that laws alone are insufficient, FATF does not provide a theoretical explanation for the frequent divergence between TC and IO scores. The methodology implicitly assumes that strong legal frameworks should translate into effective outcomes, an assumption that does not hold in many developing or high-risk jurisdictions. Countries such as Nigeria, which achieved high levels of technical alignment in the 2021 Mutual Evaluation, continue to record modest or low effectiveness ratings across several IOs (GIABA, 2021).

This persistent divergence indicates a deeper structural problem that FATF does not explicitly theorise. The emerging concept of paper versus

functional compliance therefore fills a major conceptual gap by describing not only the presence of formal compliance but also the systemic barriers that prevent those frameworks from generating meaningful enforcement outcomes.

2.2. Anti-Money Laundering (AML) And Counter-Terrorism Financing (CTF)

The scholarly literature on AML and CTF implementation provides important insights into weak operational performance but does not fully conceptualize the underlying gap between formal and functional compliance. Early studies by Reuter and Truman (2004) and Levi and Reuter (2006) highlight the limited deterrent effect of global AML efforts, noting that countries often adopt sophisticated laws without achieving proportional enforcement outcomes.

Similarly, works such as Naylor (2002) examine how informal economies and cash-based transactions undermine AML controls, while Mugarura (2014) links poor enforcement to corruption, low state capacity, and institutional fragmentation. More recent literature focuses on structural asymmetries in global governance. De Koker (2024) explores how international standardization pressures compel states to adopt FATF rules even when domestic realities make full implementation difficult. Studies on FATF grey listing, like that of Pavlidis (2021), show that peer pressure and market reactions can prompt rapid legislative reforms, yet do not guarantee functional improvements.

Despite these contributions, the literature leaves several issues unaddressed. Existing studies rarely conceptualize “paper compliance” as a distinct regulatory phenomenon; differentiate between formal adoption and operational performance; analyze why high technical compliance does not necessarily lead to improved effectiveness and integrate contextual factors (e.g., informality, conflict zones, resource constraints, political interference) into a holistic framework of compliance failure.

Thus, the existing literature identifies symptoms such as low enforcement or high corruption but does not theorize the structural gap between the law “on the books” and the law “in action.” Your concept directly addresses this gap by offering a systematic framework that distinguishes between formal adherence and functional enforcement.

2.3. Defining Paper Vs Functional Compliance

The proposed conceptual framework distinguishes analytically between paper compliance and functional compliance, illustrating how

countries and jurisdictions can excel in one and fail in the other. Paper compliance refers to the formal, measurable adoption of AML and CFT policies, laws, and institutional structures. It includes legislative instruments such as the Money Laundering (Prevention and Prohibition) Act 2022 and the Terrorism (Prevention and Prohibition) Act 2022; institutional arrangements of Nigerian Financial Intelligence Unit (NFIU), Economic and Financial Crimes Commission (EFCC), Special Control Unit against Money Laundering (SCUML), Central Bank of Nigeria (CBN) supervision; development of National Risk Assessments; issuance of guidelines, circulars, beneficial ownership (BO) registers, and reporting frameworks and establishment of inter-agency committees and regulatory bodies. Paper compliance is highly visible, relatively easy to document, and forms the basis of FATF's technical compliance assessment. It reflects a state's willingness or geopolitical need to align formally with global norms (Sharman, 2011).

Furthermore, functional compliance, by contrast, refers to the degree to which AML and CFT systems operate effectively in practice, producing measurable enforcement outcomes. It involves the quality and not just quantity of suspicious transaction reports (STRs) and currency transaction reports (CTRs); the conversion of financial intelligence unit (FIU) intelligence into investigations and prosecutions; successful money laundering and terrorism financing convictions and asset recovery; real enforcement of targeted financial sanctions; effective supervision of DNFBPs; operational beneficial ownership transparency; disruption of terrorist financing channels, especially in conflict-affected zones and actual enforcement at borders and within financial institutions. Functional compliance highlights the operational capacity, autonomy, integrity, and resources of the implementing institutions dimensions often overlooked in traditional compliance assessments (Demetis, 2018).

The distinction between paper and functional compliance introduces a conceptual tool that captures the multi-layered nature of AML and CFT implementation in complex governance environments. While FATF differentiates between technical compliance and effectiveness, it does not explain why high levels of formal alignment frequently fail to produce corresponding enforcement outcomes. Nor does it systematically account for structural impediments such as political interference, fragmented institutions, limited resources, or widespread informality all of which are central to the Nigerian context.

Therefore, with a coherent analytical framework, the concept of paper versus functional compliance bridges this gap and offers an original contribution to literature. It advances understanding of why global AML and CFT standards often succeed in transforming legal systems but fall short in achieving meaningful, real-world impact. This conceptual foundation sets the stage for the empirical analysis that follows in subsequent sections of the study.

3. METHODOLOGY

This study adopts an exploratory qualitative research design to examine why formal adoption of FATF anti-money laundering and counter-terrorism financing standards ("paper compliance") frequently fails to translate into effective enforcement outcomes ("functional compliance") in developing and high-informality contexts. A qualitative approach is particularly appropriate because AML and CFT effectiveness is shaped by institutional behaviour, political incentives, enforcement practices, and contextual constraints that are not adequately captured by quantitative compliance indicators or aggregate performance metrics.

3.1. Research Design

Nigeria was selected as an empirical case due to its analytical relevance rather than representativeness. As Africa's largest economy, a major financial hub in West Africa, and a jurisdiction subject to repeated FATF and GIABA evaluations, Nigeria provides a theoretically rich setting for examining the divergence between technical compliance and effectiveness. The country exhibits extensive formal alignment with FATF standards alongside persistently weak operational outcomes across several Immediate Outcomes, making it a critical case for theory development on compliance gaps in global AML and CFT governance.

The study is theory-building rather than hypothesis-testing. It seeks to identify underlying mechanisms that explain the persistence of compliance gaps, rather than to measure the magnitude of specific outcomes. This design aligns with interpretive and institutional approaches commonly used in governance and regulatory research.

3.2. Data Collection

Data were triangulated from three primary sources to enhance credibility and analytical depth. First, thirty-six semi-structured interviews were conducted with senior regulators, financial intelligence officials, law-enforcement and security

agencies, compliance officers in financial institutions, DNFBPs, non-profit organizations, and academic experts. Interviewees were purposively selected based on their direct involvement in AML and CFT policy formulation, supervision, investigation, prosecution, or implementation. This elite sampling strategy enabled access to insider perspectives on both formal compliance processes and practical enforcement constraints.

Second, two focus group discussions were conducted to capture sector-specific experiences and collective dynamics. One focus group comprised regulators and security agencies, while the second brought together representatives from financial institutions and DNFBPs. These discussions facilitated interaction among participants and helped surface shared challenges, contested interpretations, and coordination failures that are not always visible in individual interviews.

Third, documentary analysis was undertaken using FATF and GIABA Mutual Evaluation Reports and follow-up reports, national money laundering and terrorism financing risk assessments, AML and CFT legislation, regulatory guidelines, and institutional reports. Documentary sources were used both to contextualize interview data and to assess the formal dimensions of compliance against which functional outcomes were evaluated.

3.3. Data Analysis

All interview and focus group data were analyzed using thematic analysis. This method was chosen because it allows for systematic identification of recurring patterns across diverse data sources while remaining sensitive to context and meaning. Coding proceeded iteratively, combining deductive themes informed by the literature (e.g., technical compliance, effectiveness, state capacity, institutional coordination) with inductive themes emerging from the data.

Furthermore, key analytical themes included symbolic compliance, enforcement gaps, informality, identity and beneficial ownership constraints, investigative capacity, inter-agency fragmentation, political interference, DNFBP supervision, and insecurity. Data saturation was achieved when additional interviews no longer generated substantively new themes, indicating sufficient depth for analytical interpretation.

Triangulation across interviews, focus groups, and documentary sources was used to enhance validity and reduce reliance on single-source accounts. Divergent views were examined rather than excluded, particularly where they revealed

institutional tensions or sectoral differences in compliance experiences.

3.4. Ethical Considerations

Ethical standards were strictly observed throughout the research process. All participants provided informed consent and were assured of anonymity and confidentiality. Identifying information was removed from transcripts, and data were securely stored. Given the sensitivity of AML and CFT enforcement and security-related issues, particular care was taken to protect participants from potential professional or institutional risk.

Together, these methodological choices provide a robust empirical foundation for analyzing the structural divergence between paper and functional compliance in Nigeria's AML and CFT regime and for developing a transferable analytical framework relevant to other developing and fragile jurisdictions.

4. PAPER-FUNCTIONAL COMPLIANCE GAP: EMPIRICAL FINDINGS

The empirical findings reveal a pronounced divergence between Nigeria's extensive FATF-aligned legal and institutional architecture and its limited operational outcomes in combating money laundering and terrorism financing. While formal compliance structures are well established, their practical enforcement remains weak across multiple dimensions of the AML/CFT system. This section presents the findings in two parts: evidence of strong paper compliance and evidence of weak functional compliance.

4.1. Evidence Of Strong Paper Compliance

Nigeria demonstrates a high level of formal alignment with FATF international standards through comprehensive legislation, institutional frameworks, and regulatory instruments. Key statutes, including the Money Laundering (Prevention and Prohibition) Act 2022, the Terrorism (Prevention and Prohibition) Act 2022, and the Proceeds of Crime (Recovery and Management) Act 2022, collectively criminalize money laundering and terrorism financing, impose reporting obligations, and define institutional mandates consistent with FATF Recommendations.

Interview data consistently confirmed the robustness of Nigeria's formal framework. A senior regulator described the legal architecture as "some of the best AML and CFT laws in Africa" (Regulator interview). This assessment aligns with findings in GIABA Mutual Evaluation and follow-up reports, which acknowledged the breadth and sophistication

of Nigeria's legislative reforms despite noting effectiveness concerns (GIABA, 2021).

Institutionally, Nigeria has established all core bodies required under FATF standards. These include the Nigerian Financial Intelligence Unit (NFIU), restructured in 2018 to enhance operational independence; the Economic and Financial Crimes Commission (EFCC) as the lead investigative agency; the Special Control Unit against Money Laundering (SCUML) for DNFBP supervision; and the National Counter Terrorism Centre (NCTC) for terrorism financing coordination. In addition, inter-agency structures such as the National AML and CFT Committee and the National Sanctions Committee provide formal coordination platforms. These arrangements collectively satisfy the institutional criteria assessed under FATF technical compliance (GIABA, 2024).

Regulatory authorities, including the Central Bank of Nigeria (CBN), the Securities and Exchange Commission, and the National Insurance Commission (NAICOM), have issued extensive AML and CFT guidelines covering customer due diligence, enhanced due diligence, suspicious transaction reporting, sanctions screening, and internal control requirements. Regulated financial institutions were found to maintain documented compliance manuals, dedicated AML units, and risk-based monitoring systems. These elements demonstrate that Nigeria meets and in some areas exceeds, the formal benchmarks associated with FATF technical compliance. As at November 2025, Nigeria is either compliant or Partially Compliant on 38 out of 40 FATF recommendations (GIABA, 2024).

4.2. Evidence Of Weak Functional Compliance

Despite strong formal frameworks, the findings reveal persistent weaknesses in operational performance across key AML and CFT domains. A central theme emerging from interviews was the limited conversion of financial intelligence into effective enforcement outcomes. Investigators and intelligence officers repeatedly highlighted low rates of progression from suspicious transaction reports (STRs) to full investigations, a small number of prosecutions relative to predicate crime levels, and even fewer convictions for complex money laundering and terrorism financing offences.

As one senior investigator noted, "We receive intelligence, but most cases do not progress because the evidence is not traceable" (Law enforcement interview). This gap between intelligence generation and prosecutorial outcomes reflects systemic investigative and evidentiary constraints rather than

isolated failures.

Furthermore, beneficial ownership (BO) transparency emerged as another major area of weak functional compliance. Although BO disclosure requirements exist in law, participants described verification as largely ineffective in practice. Fragmented identity systems, unreliable address information, the prevalence of shell or dormant companies, and resistance from professional gatekeepers were identified as key barriers. A regulator explained that "BO disclosure exists in law, but verification is almost impossible" (Regulatory interview). These findings indicate that BO reforms remain largely symbolic, limiting their utility for investigations and asset tracing.

The findings also demonstrate that terrorism financing in Nigeria operates predominantly outside the formal financial system. Security-sector participants emphasised that most terrorism financing activities involve cash-based transactions, informal taxation by insurgent groups, livestock and commodity trade, smuggling networks, and unregulated money or value transfer services. As one security official observed, "Our terrorism financing frameworks assume banks. Terrorists do not use banks" (Security agency interview). This structural mismatch severely limits the effectiveness of bank-centric FATF tools such as STRs and targeted financial sanctions.

DNFBPs were identified as one of the weakest components of Nigeria's AML and CFT regime. Evidence from interviews and focus group discussions revealed low awareness of AML and CFT obligations, minimal internal compliance structures, and near absence of STR reporting across DNFBP sectors, including real estate, legal services, accounting, and dealers in precious metals and stones. Several DNFBPs perceive AML and CFT requirements as banking-specific, resulting in negligible behavioural change.

These compliance failures compounded by institutional capacity constraints within SCUML, whose supervisory mandate covers tens of thousands of entities but is undermined by limited staffing, funding, technological resources, and enforcement authority. Inspections were described as infrequent, rare sanctions, and follow-up weaknesses, creating a low-risk environment for non-compliance. As one practitioner stated, "We know the law exists, but nobody has trained us or checked on us" (DNFBP interview).

In the banking sector, although STR volumes are high, participants noted that many reports are defensive in nature, submitted primarily to satisfy

regulatory requirements rather than to provide actionable intelligence. Feedback loops between the NFIU and reporting entities were described as weak, and terrorism financing related STRs were considered disproportionately low relative to Nigeria's risk profile.

Insecurity was identified as a major structural constraint on functional compliance. Ongoing insurgency, banditry, and communal violence have rendered large rural and border regions inaccessible to effective law enforcement. In these areas, non-state armed groups reportedly exercise de facto territorial control, operate parallel governance systems, and rely heavily on cash-based financing mechanisms. Porous borders and unregulated routes further undermine cross-border controls and sanctions implementation. As one intelligence officer explained, "You cannot implement terrorism financing sanctions in places you cannot physically reach" (Security agency interview).

Finally, the organized crime index rankings for Nigeria in 2021 and 2023 shows a global shift from 5th to 6th in the world but Nigeria maintained its 2nd position in Africa and 1st position in West Africa (GITOC, 2024). In world Cyber Crime Index, Nigeria is ranked 5th in the world below Russia, Ukraine, China and United States in 1st - 4th positions respectively (University of Oxford, 2024). Moreover, on a scale of 0 to 10, Nigeria scored 7.587 in 2024 down from 7.897 in 2014 thus, maintaining its position in the top 10 countries on the state of terrorism in Nigeria by the Global Terrorism Index (Vision of Humanity, 2024). The Basel Anti-Money Laundering Index (susceptibility to money laundering and terrorism financing) ranked Nigeria on 17th position out of 164 in 2024 with a score of 6.85 (Basel Institute of governance, 2025)

The findings demonstrate a consistent pattern; while Nigeria exhibits strong paper compliance through laws, institutions and regulatory frameworks, functional compliance remains weak due to structural, institutional, and security-related constraints. This divergence provides empirical grounding for the paper-functional compliance framework developed in the subsequent discussion.

5. DISCUSSION: DEVELOPING THE PAPER-FUNCTIONAL COMPLIANCE CONCEPT

The empirical findings outlined in the preceding section demonstrate a systematic divergence between Nigeria's extensive FATF-aligned reforms ("paper compliance") and its limited operational outcomes ("functional compliance"). This section

synthesizes these observations into a broader conceptual framework and shows how the paper-functional compliance distinction advances understanding of AML and CFT governance in developing and high-informality states. In doing so, it extends existing debates on state capacity, regulatory adoption, and global governance.

5.1. Paper Vs Functional Compliance as a Structural Condition

The findings indicate that the divergence between paper and functional compliance cannot be understood merely as an implementation problem or a temporary lag. Instead, it constitutes a structural condition of Nigeria's AML and CFT system. This gap emerges because paper compliance is driven primarily by external incentives, whereas functional compliance is shaped and constrained by internal structural realities.

Paper compliance reflects the state's willingness and ability to adopt global standards, often through rapid legislative reform, institutional creation, and policy alignment. Functional compliance reflects the state's capacity to operationalize these standards in practice, which depends on resources, political will, institutional integrity, bureaucratic coordination, and socio-economic context. Thus, paper compliance refers to the formal alignment of national laws, regulations, and institutional frameworks with FATF expectations, whereas functional compliance denotes the extent to which these frameworks translate into effective real-world enforcement, supervision, and impact.

The asymmetry between these two dimensions creates a two-tiered AML and CFT order, where formal conformity coexists with weak implementation. This pattern is observable across many developing countries, particularly those characterized by large informal economies, low regulatory capacity, and fragmented governance arrangements (Reuter & Truman, 2004; de Koker, 2024). Nigeria exemplifies this structural dichotomy.

5.2. Drivers Of Paper Compliance

Nigeria's strong paper compliance arises from several reinforcing external and political dynamics. External pressures include the reputational risks of grey listing, potential economic sanctions, and the need to maintain correspondent banking relationships. These make legal and institutional alignment a strategic priority for policymakers. In addition, peer review mechanisms under FATF and GIABA create further incentives for governments to demonstrate commitment through visible reforms.

Furthermore, adopting legislation is inexpensive compared to enforcement. As observed in other regulatory domains, passing laws provides political benefits without demanding major resource commitments (Buscaglia & Dijk, 2003). It allows political actors to claim progress, satisfy FATF benchmarks, improve diplomatic standing, and also generate favourable evaluations in technical compliance assessments. These incentives help explain why legislative reforms often outpace operational capacity-building.

Furthermore, technical compliance ratings can be upgraded rapidly through legal amendments, unlike effectiveness ratings which require long-term institutional transformation. The relative ease of improving TC thus encourages governments to prioritize normative alignment over deeper structural reforms.

5.3. Drivers Of Weak Functional Compliance

In contrast, Nigeria's weak functional compliance arises from deep-rooted institutional and socio-economic constraints that limit the operationalization of AML and CFT measures. Weak investigative infrastructure limited forensic capabilities, poor data integration, and inadequate intelligence management systems constrain the ability of agencies such as the NFIU, EFCC, and Nigeria Police Force (NPF) to convert STRs into enforceable cases. These challenges mirror findings in comparative research that highlight enforcement bottlenecks in low-capacity jurisdictions (Levi & Reuter, 2006).

Functional compliance is undermined by fragmented identity systems, unreliable address verification mechanisms, and the absence of a consolidated beneficial ownership system. These weaknesses make it difficult to trace illicit flows, enforce due diligence, or verify corporate structures conditions that FATF assumes to be in place, but which are often lacking in developing contexts.

Nigeria's predominantly cash-based economy, coupled with large informal sectors in real estate, trade, and DNFBNs, reduces the effectiveness of formal AML and CFT controls. Informal value transfer systems, smuggling networks, and unregulated commerce allow illicit financial flows to bypass the regulated financial sector entirely.

Political interference in investigations, selective enforcement, and corruption within key institutions create structural barriers to effective AML and CFT implementation. These governance deficits weaken prosecutorial momentum and reduce the credibility of enforcement agencies.

Persistent insecurity, especially in the North-East and parts of the North-West, severely limits the state's ability to enforce terrorism financing-related controls. Illicit trade corridors, insurgent-dominated regions, and ungoverned border spaces undermine FATF-related expectations such as terrorism financing sanctions implementation or intelligence-led disruption of terrorism financing-networks. Collectively, these factors explain why formal compliance does not translate into operational effectiveness.

5.4. Why The Paper-Functional Gap Persists

The persistence of this gap reflects a fundamental misalignment between FATF's theoretical assumptions and Nigeria's structural realities. FATF's model presupposes the traceability of financial transactions, a robust national identification infrastructure, formalized economic activity, centralized and coordinated enforcement systems, reliable supervision across all sectors and accountable governance structures.

These assumptions correspond more closely to developed economies than to highly informal, low-capacity states. Consequently, paper reforms cannot achieve functional compliance unless accompanied by broader structural transformation including improvements in governance, formalization of the economy, enhanced identity systems, inter-agency integration and territorial security.

6. PAPER-FUNCTIONS IMPLICATIONS FOR THEORY AND POLICY

The conceptual and empirical insights developed in this paper have significant implications for both academic debates and policy practice in global AML and CFT governance. By examining the persistent divergence between paper and functional compliance in Nigeria, the study contributes to theoretical refinement and offers concrete recommendations for national authorities, regional bodies, and international partners.

6.1. Theoretical Implications for Anti-Money Laundering and Counter Financing of Terrorism

6.1.1. Extending Compliance Theory

Traditional compliance literature emphasizes three dominant pathways to compliance: deterrence, normative alignment, and state capacity (Mitchell, 1994; Chayes & Chayes, 1995). Yet these frameworks tend to assume that once a state adopts international norms and has some capacity and incentives, implementation will naturally follow.

The findings of this study introduce a fourth dimension of “structural feasibility of implementation”. The paper-functional compliance concept shows that even when deterrence pressures exist (e.g., grey listing), even when states normatively align with FATF international standards, and even when capacity-building investments are made, structural constraints may still prevent functional implementation. This insight extends compliance theory by demonstrating that adoption is not equivalent to enactment, and that execution depends on deeper socio-economic and institutional conditions.

6.1.2. Refining Liberal Institutionalism

Liberal Institutionalism asserts that international institutions shape state behaviour through norm diffusion, peer review, and socialization mechanisms (Keohane, 1984; Finnemore & Sikkink, 1998). FATF’s global influence is often cited as a textbook example of this process.

However, the evidence from Nigeria shows that institutional influence is not uniform. Global norms diffuse rapidly on paper, producing legislative reforms and institutional proliferation but have limited behavioural impact where states lack functional reach, territorial control, or administrative coherence. This study therefore refines Liberal Institutionalism by demonstrating that institutional influence is bounded, not absolute. It works effectively in formal domains but falters in environments where state structures are weak, fragmented, or contested.

6.1.3. Bridging Technical Compliance and Effectiveness

Although FATF analytically distinguishes between TC and Effectiveness, it does not theorise why they diverge so sharply in many jurisdictions. The paper-functional compliance framework provides a mechanism for understanding this gap, showing that structural constraints create a persistent disjunction between the formal presence of standards and their practical application. This offers a significant contribution to AML and CFT theory by connecting FATF’s quantitative scoring system with a deeper explanatory model.

6.2. Policy Implications for Nigeria

The findings of this study underscore the urgent need for Nigeria to transition from an AML and CFT reform paradigm centred predominantly on legislative alignment toward one grounded in the development of functional operational capacity.

While Nigeria has made commendable progress in establishing FATF-aligned laws and regulatory frameworks, these formal structures remain insufficient without the institutional, technical, and infrastructural capabilities necessary for meaningful enforcement. Four major policy priorities emerge from the analysis.

6.2.1. Institutional Reform

Institutional reform must move beyond legal adoption. The evidence demonstrates that legislation alone cannot deliver AML and CFT effectiveness. Nigeria must therefore invest in the foundational systems that render enforcement feasible. This includes strengthening national identity infrastructure through full integration of the National Identification Number (NIN), improving address verification mechanisms, and establishing a reliable and interoperable BO verification system. Functional sanctions implementation frameworks capable of monitoring, identifying, and freezing designated assets are also essential. Without these structural elements, AML and CFT laws remain nominal rather than operational. Furthermore, Nigeria must enhance its end-to-end investigative and prosecutorial processes to enable credible enforcement actions across the entire spectrum of AML and CFT mandates.

6.2.2. Strengthening Operational and Investigative Capacity

Achieving functional compliance requires Nigeria to prioritize operational capacity-building across all AML and CFT institutions. This includes the development of advanced forensic and digital investigation units capable of tracking complex financial flows, cyber-enabled transactions, and cross-border illicit finance. Key agencies such as the NFIU and EFCC must be equipped with modern analytic tools, integrated databases, and real-time intelligence-processing capabilities. Additionally, the establishment of specialised terrorism financing investigation teams is necessary to address the unique challenges associated with informal and non-financial terrorism financing channels. Sustained investment in training, professional development, and budgetary support is indispensable. Without these resources, STRs, BO data, and targeted financial sanctions designations will remain symbolic, rather than actionable.

6.2.3. Enhancing Inter-Agency Coordination

Weak coordination represents one of the most significant barriers to functional compliance. Strengthening intelligence-sharing mechanisms among key institutions is therefore critical. Improved communication flows are needed between the NFIU and frontline enforcement agencies such as the EFCC and NPF, as well as between the Department of State Services (DSS) and the NCTC. Regulatory bodies including the CBN) and SCUML must also coordinate more effectively to ensure coherent supervision of reporting entities. Developing interoperable databases, shared platforms, and joint task forces would significantly enhance Nigeria's ability to convert financial intelligence into enforceable outcomes.

6.2.4. Targeting High-Risk and Weakly Supervised Sectors

The study highlights the need to prioritize sectors that contribute disproportionately to money laundering and terrorist financing risks. These include the real estate sector, legal and accounting professions, Bureau de Change operators, informal money lenders, and dealers in precious metals and stones. Many of these DNFBP sectors operate with minimal supervision due to resource constraints, regulatory fragmentation, or limited awareness of AML and CFT obligations. Targeted supervision, risk-based inspections, sector-specific guidance, and awareness programmes are therefore essential to closing these persistent vulnerabilities.

6.3. Implications For Financial Action Task Force and Inter-Governmental Action Group Against Money Laundering in West Africa

The findings also have important implications for FATF and its regional body, GIABA, particularly in the context of assessing compliance in developing and high-informality jurisdictions.

6.3.1. Acknowledging Structural Barriers in Assessments

FATF's current evaluation framework must more explicitly recognize the structural impediments faced by countries such as Nigeria. Jurisdictions characterized by large informal economies, weak identity and BO verification systems, significant security challenges, and cash-dominant transaction cultures encounter practical obstacles that cannot be overcome through legislative reform alone. A one-size-fits-all model of effectiveness that presupposes developed-state institutional conditions risks

penalizing states for structural circumstances beyond immediate control. More context-sensitive assessment tools are therefore necessary.

6.3.2. Adapting Immediate Outcomes to Contextual Realities

FATF's Immediate Outcomes should incorporate proportionality and context-specific feasibility. In environments where a significant proportion of financial activities occur outside formal channels, expectations regarding STR volumes, TF detection through banks, or BO transparency reviews may not be realistic. Effectiveness criteria should therefore be recalibrated to account for informal financial systems, territorial insecurity, and institutional constraints intrinsic to fragile or developing states.

6.3.3. Providing Targeted and Sustained Technical Assistance

FATF and GIABA should deepen technical assistance programmes tailored to the specific challenges of Nigeria and similar jurisdictions. Priority areas include strengthening digital identity infrastructures, improving BO verification and corporate transparency frameworks, enhancing financial intelligence analysis capabilities, and developing terrorism financing disruption methodologies suited to informal or rural economic structures. Support for strengthening investigative capacity particularly in relation to predicate offences should also be prioritized.

6.4. Implications For International Partners

International partners including the European Union, United Kingdom, United States, International Monetary Fund, World Bank, and bilateral development agencies play an increasingly significant role in shaping AML and CFT reforms in developing countries. However, the findings suggest that external assistance must shift from a narrow focus on legislative conformity toward robust investment in functional capacity.

Support should prioritize operational capacity-building, including digital and forensic infrastructure, interoperable databases, cyber-enabled investigation tools, and specialized training for investigators, prosecutors, and regulators. Enhancing financial intelligence capabilities is also essential, particularly in analyzing informal terrorism financing networks and complex ML typologies unique to the West African sub-region.

Finally, external partners must deepen their understanding of Nigeria's political economy and conflict dynamics. Donor strategies that rely on

compliance checklists or assume ideal-state institutional conditions risk reinforcing paper compliance without improving functional performance. A long-term, context-sensitive approach focused on governance, accountability, and institutional resilience is therefore essential for sustainable AML and CFT reform.

7. CONCLUSION

This paper has developed the concept of paper-functional compliance to explain the persistent gap between Nigeria's formal adoption of FATF AML and CFT standards and its limited operational outcomes in combating money laundering and terrorist financing. While Nigeria demonstrates extensive technical compliance through robust legislation, institutional frameworks, and regulatory guidelines, these reforms have not translated into effective enforcement.

The empirical evidence shows that functional compliance is undermined by deep structural constraints, including pervasive informality, weak identity and beneficial ownership systems, insufficient investigative capacity, widespread corruption, inter-agency fragmentation, and significant insecurity across various regions of the country. These factors collectively create a systemic

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barrier that prevents FATF-driven reforms from producing meaningful results.

The paper-functional compliance concept offers an original analytical framework that clarifies why countries may score highly on FATF technical assessments yet remain ineffective in practice. It extends Compliance Theory by introducing structural feasibility as a necessary dimension of compliance analysis and refines Liberal Institutionalism by demonstrating the bounded nature of institutional influence in contexts where state capacity is uneven.

Policy implications include the need for Nigeria to move beyond legislative reforms and invest in operational capacity, inter-agency coordination, identity systems, and DNFBP supervision. FATF and GIABA should consider adapting their models to better account for structural realities and avoid overemphasizing symbolic compliance.

Ultimately, the concept of paper-functional compliance not only illuminates Nigeria's specific AML and CFT challenges but also offers a transferable theoretical framework applicable to other developing and fragile states. It bridges global AML and CFT expectations with grounded local realities and opens pathways for more pragmatic, context-sensitive policymaking.

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