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China's Illicit Financial Flows The Threat to Global Stabilization

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Introduction

The International Monetary Fund ("IMF") indicated that Illicit Financial Flows ("IFFs") surging from developing economies globally reached a staggering $3.5 trillion USD in 2014.[i] Every year, approximately $1 trillion USD in IFFs leave the developing world to find refuge in developed countries, money laundering and tax havens, or countries with loose anti-money laundering ("AML") and counter-terrorist financing ("CFT") laws and regulations.[ii] Where is the majority of IFFs originating from, and where specifically are these illicit funds headed? You may not be that surprised to discover that many are headed to the US! Perhaps what's even more astounding is that China is spearheading the undertaking, with total incoming and outgoing IFFs amounting to approximately $1.1 trillion USD in 2014 and approximately $6.9 trillion USD between 2005 and 2014, comparative to the volume of China's overall trade during that time. [iii]

IFFs bleed through China into the US economy and financial system every day, but a lot of this activity is presumed innocuous, as the US inadvertently enables the legitimacy of these funds and their criminal sources. How has this epidemic effortlessly infiltrated our financial system, and what fuels its existence? In this article, we will examine the mechanisms through which IFFs prosper; survey China's economic, social, and regulatory landscape; and consider how China has been able to sustain its criminal ventures for over a decade. We will then discuss policy measures that global organizations have conceived for countries to defeat and extinguish the IFF epidemic. Finally, we will delineate how US financial institutions ("FIs") can enhance their AML programs in an effort to impede Chinese IFFs from compromising their banking systems.

A Closer Look at IFFs

Before we delve into how China has pioneered the IFF movement, let's discuss the history of IFFs, what they are, and how they operate. The inception of IFFs dates back to 2005 when it was discovered that IFFs are running down the economies of developing countries by virtue of being facilitated through secrecy within the global financial system. A year later, Global Financial Integrity ("GFI") was born, an organization aimed specifically at quantifying and analyzing the flow of illegal money, advising developing countries' governments on effective policy solutions, and promoting measures within the international financial system to sustain global development and security. [iv] In collaboration with GFI, several international organizations have studied IFFs for years and have provided considerable guidance into the functionality of IFFs. In its analyses of IFFs, GFI utilizes data sources and analytical methodologies developed and used by international institutions, governments, and economists.

So, what are IFFs? IFFs are cross-border movements of money or capital in contravention of national or international laws.[v] According to the GFI's April 2017 publication, *Illicit Financial Flows from Developing Countries: 2005-2014* ("IFF Report"), the flow of funds is deemed *illicit* if the funds are illegally earned, transferred, and/or utilized across international borders. If the flow breaks a law at any point, it is illicit. [vi] According to the World Bank Group—an international organization dedicated to providing financial and technical assistance to developing countries globally through policy advice, research and analysis—the illegal activity with which IFFs are associated can be compartmentalized into three (3) categories: 1) the acts themselves are illegal (e.g., corruption or tax evasion); 2) the funds are the results of illegal acts (e.g., smuggling and trafficking in minerals, wildlife, drugs, and people); or 3) the funds are used for illicit purposes (e.g., financing of organized crime).[vii] According to the Organisation of Economic Co-operation and Development ("OECD")—an intergovernmental organization committed to promoting policies that aid in the improvement of the economic and social well-being of people globally—IFFs generate through methods, practices, and crimes generally involving money laundering, tax evasion, international bribery, and/or trade mispricing/misinvoicing. [viii]

What Drives IFFs out of China?

In GFI's October 2012 publication, *Illicit Financial Flows from China and the Role of Trade Misinvoicing* ("China Report"), GFI discusses the three (3) driving mechanisms behind the cross-border movement of illicit capital—a country's macroeconomic, structural, and governance landscape. With regard to China's macroeconomic landscape, China maintains large account surpluses that are continually increasing, leading to outflows of capital that consist of both legitimate and illegitimate capital leaving China. Additionally, elevated inflation rates also lead to IFFs through China since owners do not want to undergo a steady decrease in the real value of their holdings. Many Chinese harbor a perception that the Yuan has very little value as a result of trade surpluses.[ix]

Structural drivers also motivate the transfer of IFFs out of China. China has transitioned from an egalitarian society to a society where the rich get richer, and the poor get poorer, as a result of a large number of high net worth individuals concealing foreign holdings of illicit assets from the Chinese government. As China's high net worth individuals are also the same individuals intimately connected to the country's globalized economy—getting away with tax evasion, profit-shifting, bribery, kickbacks, trade misinvoicing, income realized through unreported external assets, and tax breaks—the burden falls on China's middle- and low-income sectors to pay higher tax margins, as the government is unable to collect from its wealthiest residents. Maintaining trade openness also promotes IFFs leaving China, as traders are furnished with more opportunities to misinvoice trade.[x]

China's governance is the third driving factor for IFFs leaving China. As we discuss in greater detail below, corruption among China's politicians, leaders, and powerful officials breeds an unstable regulatory regime, whereby the very institutions charged with safeguarding China's wealth become complicit in criminal conduct, undermining the country's currency control laws and financial regulations.[xi]

China's Safe Havens

China remains the largest exporter of IFFs. How have the Chinese been able to move vast amounts of money out of the country every year? The answer lies in China's wealthy populous and in some of China's largest banks. According to GFI, in 2014, China's CCTV unmasked the Bank of China's money laundering schemes by revealing that after China's elite invested billions of US dollars in international property and foreign assets, large banks, such as Bank of China and China Citic Bank, aided wealthy Chinese individuals in moving illicit funds abroad. How did these banks accomplish this? China's currency controls were impeding China's elite from making large foreign investments, as China's stringent currency control laws did not allow more than 50,000 yuan annually to be sent abroad by an individual. To alleviate this roadblock, Chinese banks began manipulating currency controls in China and furnishing wealthy clients *underground* banking services to facilitate the cross-border movement of funds. Although a lot of the exported wealth was legitimately obtained, some of the funds were unlawfully acquired, and the intended purpose and use of the exported funds was unclear.[xii]

As if Chinese banks being complicit with its wealthy clients in facilitating the transfer of IFFs wasn't enough, these wealthy individuals discovered another safe haven—the US. GFI indicates that China's corrupt economic fugitives, including corrupt politicians, fugitive officials, and leaders, have found refuge in the US as they fled corruption charges in their home country. Many of these fugitives, termed *naked officials*, moved their families and complete assets to the US in fear of China becoming suspicious and subsequently launching a corruption investigation against them. At face value, it doesn't appear wary that many Chinese individuals often send their children to study at prominent academic institutions in the US. After all, who doesn't want to attend Harvard University? In many instances, however, such actions involve money laundering and the theft of hundreds of billions of dollars from the Chinese economy. According to GFI, in 2011, the Central Bank of China discovered that theft conducted by corrupt officials constituted approximately 800 billion yuan ($130 billion USD) leaving the country. Between 2002 and 2011, IFFs out of China accounted for $1.08 billion USD, primarily moved by wealthy and powerful officials.[xiii]

As China and the US currently do not have an extradition treaty, the US serves as an exceptionally desirable destination in which corrupt Chinese fugitives can hide. Additionally, loose US incorporation laws make it effortless for corrupt Chinese officials to form an anonymous company in which to conceal their ill-gotten gains, even if they are not living within the US at the time of the company's formation. The GFI indicates that the US is one of the easiest destinations, for a kleptocrat, criminal, or terrorist to create an anonymous company and effectuate money laundering. In fact, many Chinese fugitives have funneled their assets through the purchase of upscale Manhattan real estate with anonymous identities, while the properties themselves remain empty, as they exclusively serve as vehicles for criminal conduct.[xiv]

IFFs through Foreign Direct Investment

One of the means by which China has moved its illicit outflows is through a round-trip of funds, whereby the funds leave China and return back to China in the form of recorded Foreign Direct Investment ("FDI"). FDIs are popular vehicles for disguising illicit funds, as they are afforded preferential treatment in China through tax concessions, government guarantee of loans extended by foreign corporations to domestic firms, land, and other facilities at concessional rates. Illicit funds can also leave China in the form of FDI, travel through Hong Kong and the British Virgin Islands ("BVI"), get laundered into a separate entity, and be reinvested in China as FDI. Such a money laundering scheme allows Chinese citizens to exploit more favorable FDI regulations, allowing China's wealthiest to secretly accumulate wealth without being subject to government regulations and oversight.[xv]

The US Department of State has deemed the BVI a jurisdiction of Primary Money Laundering Concern. The BVI's offshore financial services are often exploited, and the territory serves as an attractive and convenient venue for money launderers. The BVI maintains a share structure that does not mandate a statement of authorized capital and does not require mandatory filing of ownership information. It is a desirable destination for registering shell companies that can be instituted rapidly and for cheap.[xvi]

According to the US Department of State, a substantial percentage of BVI's offshore business comes from China.[xvii] Mainland China and Hong Kong constitute the largest foreign direct investors in each other's economy. BVI is the second largest foreign direct investor in China and Hong Kong and is the largest recipient of FDI from Hong Kong. According to the GFI, BVI invested $213.7 billion USD in mainland China in 2010, while almost all of China's investment in the BVI was routed through Hong Kong. Hundreds of billions of US dollars constituted cash deposits and financial assets in tax havens between 2005 and 2011, and approximately half of the investments emanating from China to tax havens were illegal.[xviii]

IFFs through Trade Misinvoicing/Mispricing

According to GFI's IFF Report, trade misinvoicing, a type of trade-based money laundering, is achieved by misstating the value or volume of an export or import on a customs invoice. Trade misinvoicing is a deliberate practice, made feasible by trading partners drafting their own trade documents. Trade re-invoicing occurs by having the trade documents prepared typically in a tax haven. Criminals will fraudulently manipulate the price, quantity, or quality of a good/service on an invoice, which paves the way for corrupt government officials, commercial tax evaders, and other criminal actors to rapidly and effortlessly move large quantities of funds from one country to another. As IFFs are covert by nature, trade misinvoicing is almost never detected.[xix]

How much of China's total trade constitutes IFFs generally, and how much of it constitutes trade misinvoicing? In its IFF Report, GFI reviewed country-specific data, acquired through the IMF, pertaining to IFFs and trade misinvoicing for 2014 and for the period of 2005-2014. GFI reported that in 2014, China's total trade volume amounted to $4.3 trillion USD. Of the $4.3 trillion, approximately $1.1 trillion consisted of illicit outflows (~$258 billion) and illicit inflows (~$861 billion) in the form of IFFs; and approximately $990 billion consisted of illicit outflows ($129 billion) and illicit inflows ($861 billion) in the form of trade misinvoicing.[xx]

GFI reported that for the period of 2005-2014, China's total trade volume amounted to $29 trillion USD. Of the $29 trillion, approximately $6.9 trillion consisted of illicit outflows (~$1.4 trillion) and illicit inflows (~$5.5 trillion) in the form of IFFs; and approximately $6.6 trillion consisted of illicit outflows ($1.1 trillion) and illicit inflows ($5.5 trillion) in the form of trade misinvoicing.[xxi]

Though trillions of US dollars may seem unfathomable, there still exist multiple forms of IFFs that are incapable of being measured using available economic data and methods. Cash transactions, same-invoice faking, misinvoicing in services and intangibles, and hawala transactions are some of the IFF variations that simply cannot be presently quantified.[xxii]

International Policy Measures Designed to Curtail IFFs

IFFs are permitted to thrive in the developing world when secrecy governs the global financial sector. This absence of transparency cultivates tax havens, secrecy jurisdictions, anonymous trusts and shell companies, money laundering, bribery, and corruption. International organizations, such as GFI, the United Nations, the World Bank Group, the IMF, and the OECD have collectively developed several policy measures for countries to implement, designed specifically to curtail IFFs. These policy measures are described in detail below.[xxiii]

1. **Beneficial ownership of all legal entities should be known.** *Beneficial owners* include the ultimate, true, human owner(s) of all corporations and other legal entities. This information should be provided upon formation, should be updated regularly, and should be freely available to the public through central registries established by the country's government. Gatekeepers to the financial system, such as lawyers, accountants, corporate service providers, and FIs, should be required to identify the beneficial owners of any account or client relationship established. As anonymous companies and other legal entities are particularly problematic, identification of all banking and securities accounts should be known.

2. **Government authorities should espouse and implement the Financial Action Task Force ("FATF") Recommendations** to combat money laundering and terrorist financing. Government regulators and law enforcement should work together to enforce all national AML laws and regulations and impose appropriate penalties against those who contravene these laws and regulations.

3. **Multinational corporations should be required by all countries to publicly disclose their revenues, profits, losses, sales, taxes paid, subsidiaries, and staff levels** on a country-by-country basis so that tax evasion and other tax crimes can be prevented and identified. If countries maintain relevant jurisdiction over the companies within those countries, country-by-

country reporting should be implemented so legislators can accordingly address issues identified by strengthening applicable legislation.

4. **All countries should become a part of the global movement toward the automatic exchange of financial information,** the standards for which have been put forth by the OECD and G20. Developing countries, such as China, should be included as part of this process.

5. **As trade misinvoicing formulates a monumental volume of IFFs, policymakers should prioritize curtailing the phenomenon.** The highest level of scrutiny should be prescribed to trade transactions with secrecy jurisdictions and tax havens. Additionally, customs enforcement officers should be appropriately trained on the intricacies and red flags associated with trade misinvoicing and should be granted access to the most recently available world market pricing information, with special attention paid to commodity types.

6. **Governments should sign onto the Addis Tax Initiative,** a 2015 agreement that resulted from the most recent Financing for Development Conference, primarily focused on alleviating the IFF global epidemic.

The Role of US Financial Institutions

Where do US FIs fit in the global fight against IFFs? How can the US financial system prevent IFFs from touching them and promptly detect IFFs if prevention is not feasible? In truth, simply having an AML program is not enough. Financial intelligence involves continual enhancement of an FI's overall AML framework and a collaborative cross-border agenda, whereby US FIs regularly and effectively communicate with foreign FIs to combat financial crime, especially crime achieved through practices such as IFFs, which are in and of themselves hidden and unobservable.

As part of an FI's comprehensive AML program, operational activities such as Know Your Customer ("KYC"), Suspicious Activity Reporting ("SAR"), Currency Transaction Reporting ("CTR"), and Watch List Management ("WLM") can be segregated within the AML program, and subsequently compartmentalized even further. For example, an FI's KYC program may have a unit of AML personnel dedicated to the CDD function, a separate unit of AML personnel dedicated to the EDD function, and a third unit of front-line personnel dedicated to the Customer Identification Program ("CIP") function. Within the CDD group, a small number of AML personnel may be focused on beneficial ownership identification of legal entity customers, while another set of AML personnel focuses on executing ongoing CDD reviews.

As another example, an FI's CTR program can consist of a compilation of international CTR laws and regulatory guidelines, in addition to US CTR regulations, pertaining to countries that the FI transacts with regularly and/or countries that are at high-risk for money laundering and terrorist financing. As previously mentioned, China's currency control laws do not allow more than 50,000 yuan annually to be sent abroad by an individual. This could mean criminals potentially structuring currency transactions to circumvent the currency restrictions in an effort to rapidly move large amounts of currency out of China, without having a CTR generated. Knowledge of China's currency control laws would allow CTR personnel at your institution to be able to effectively identify suspicious currency transactions involving Chinese institutions, subsequently enhancing international suspicious activity reporting at your institution.

Your overall AML program is as effective as the knowledge base of your personnel. Encouraging personnel to read relevant literature on the current efforts of international AML organizations may be paramount in shaping a proactive AML program that is substantially distinct from other FIs. Cross-border

AML methodologies are constantly evolving, and criminals are constantly discovering different countries through which to perpetuate their illicit conduct.

An enhanced AML training program can be argued as perhaps the most critical element in sustaining the integrity of your FI. AML training directed at both AML personnel and front-line personnel can be more targeted, as opposed to generalized, and pertain to more atypical, covert, and novel methods of money laundering. Many FIs develop AML training programs that are generalized, meeting only the minimum requirements of the AML training pillar. A strong AML training program provides personnel with knowledge regarding the current global regulatory and legal landscape, consisting of components such as new and relevant rulemaking by the Financial Crimes Enforcement Network ("FinCEN"), the imposition of US sanctions and special measures by FinCEN, changes in AML legislation, how current world events may impact your particular FI, etc. This may also entail providing information regarding a specific country and that country's unique vulnerabilities to money laundering and/or terrorist financing. Personnel should also be educated about financial crimes that are either currently emerging as part of the global AML landscape, or financial crimes involving specific vehicles of money laundering that have been exploited in other countries or are starting to get exploited in other countries.

Ask yourself, does your FI's AML program currently involve training pertaining to IFFs? How many AML professionals within your FI can intelligently speak to what IFFs are, how China's banking system circumvents AML laws and regulations to perpetuate IFFs, and how IFFs threaten the US economy? These are pertinent AML areas of concern that endanger multiple US FIs' and other countries' banking systems, such as China's and Hong Kong's. When should training occur? Generalized AML training should be implemented at least annually. Targeted training, however, can be situated around the timeframe AML issues surface through the media, political sphere, global legislation, international AML organizations, etc.

As an FI that wishes to train AML personnel on the contents of this article, what can you do specifically to address the issue of IFFs leaving China? Leveraging FinCEN is always a great place to start. FIs may want to train AML personnel on where they can find recent rulemaking and sanctions information, or may even incorporate this research element into the AML program's alert/case investigative procedures and processes. For example, On November 2, 2017, FinCEN issued a Final Rule, imposing a Special Measure against China's Bank of Dandong and deeming the bank to be a financial institution of primary money laundering concern. What led to this regulatory measure against this Chinese bank? It was discovered that the Bank of Dandong primarily served as a gateway for the Democratic People's Republic of Korea ("DPRK"), a heavily sanctioned nation, to gain access to the US and international financial systems as a means to circumvent US and UN sanctions. Accounts at the Chinese bank were involved in facilitating millions of dollars of transactions on behalf of companies that were used to obtain weapons of mass destruction.[xxiv] AML training related to illicit funds flowing through China may involve drawing connections between China's IFFs and the DPRK as a potential source of funds for the IFFs. Training may also involve a consideration of whether AML and front-line personnel should beware of other Chinese banks potentially being used as a conduit for the DPRK's unlawful conduct as a means to access the US financial system, since the Bank of Dandong has been sanctioned by the US. Has your FI provided such a training?

Conclusion

IFFs pose a dire threat to US and global social, political, and economic stabilization. Understanding the principal origins of IFFs is critical in the global fight against money laundering. As the primary exporter of IFFs and chief trading partner of the US, economic surges and downfalls in China invariably affect the US economy and banking systems. According to the US Department of Commerce, the US trade deficit has increased in 2017 by 11%, as US businesses and consumers have purchased more Chinese goods and services in 2017 than China has from the US.[xxv] With so much capital leaving China for US entry, US FIs should continually be thinking about the global crisis of IFFs perpetuated through trade misinvoicing, and especially the staggering aforementioned volumes of trade capital that have historically constituted illicit outflows through China. The benefits of keeping yourself informed of precisely *how* your FI can be compromised by potentially unlawful transactions with developing countries and *what* policy measures other FIs have implemented around the world to deal with similar issues will resonate within your enterprise for years to come.

Has your financial institution been a conduit for IFFs from China or from other developing economies? Our Financial Crimes Advisory professionals at AML RightSource are continually developing new AML methodologies and enhanced processes that entail risk mitigation strategies to counter emergent global AML threats. Allow us to help you design a distinct AML Program, specifically tailored to your FI's risk profile. Please visit http://amlrightsource.com/financial-crimes-advisory-services/ to find out more information about the services we provide.

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[iv] Global Financial Integrity, *supra.*

[v] "Illicit Financial Flows from Developing Countries: Measuring OECD Responses." Organisation for Economic Co-operation and Development, 2014, https://www.oecd.org/corruption/Illicit_Financial_Flows_from_Developing_Countries.pdf

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[xvi] "2015 International Narcotics Control Strategy Report, Volume II: Money Laundering and Financial Crimes." U.S. Department of State, https://www.state.gov/j/inl/rls/nrcrpt/2015/vol2/239060.htm

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[xviii] Freitas, *supra.*

[xix] "Illicit Financial Flows to and from Developing Countries: 2005-2014," *supra.*

[xx] *Id.*

[xxi] *Id.*

[xxii] *Id.*

[xxiii] *Id.*

[xxiv] "Imposition of Special Measure against Bank of Dandong as a Financial Institution of Primary Money Laundering Concern." Financial Crimes Enforcement Network, U.S. Department of the Treasury, 2017 November 2, https://www.fincen.gov/sites/default/files/federal_register_notices/2017-11-02/Bank%20of%20Dandong%20311%20Final%20Rule.pdf

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