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China Emerging as an Increasing Driver of Global Illicit Finance Risk

Summary

Growing Chinese illicit finance threats, vulnerabilities, and exposure are combining to increase illicit financing risk in the international financial system, judging from a series of recent advisories, sanctions actions, investigations, and assessments. Discrete illicit financing threats are exacerbated by serious deficiencies in China's domestic anti-money laundering/countering the financing of terrorism (AML/CFT) regime, increasing the risk criminal and suspect actors operating in China or through Chinese financial institutions pose to global banks and multinational corporations. These risks grow more present and complicated as global exposure to China is increasing, with its international trade and investment footprint expanding both in volume and geographic reach.

- China's economy faces a wide variety of money laundering threats. China has become a manufacturing center for illegal drugs[1] and counterfeit goods,[2] suffers from deeply rooted corruption,[3] and is home to markets and networks driving wildlife and arms trafficking.[4] China also is a major destination country for the proceeds of bank fraud.[5]
- Major Chinese companies are alleged to have developed and employed sophisticated policies and procedures to evade U.S. sanctions, including on Iran and other jurisdictions.[6] Multiple large Chinese financial institutions have also been implicated in North Korean sanctions evasion schemes.[7]
- The Financial Action Task Force (FATF) found that China had a low level of effectiveness in implementing measures designed to prevent illicit finance.[8] Because of China's extensive international economic and financial engagement, other jurisdictions and global financial institutions and companies are exposed to this vulnerability.

Effectively managing China-related risk requires financial institutions and other companies to develop a comprehensive understanding of both the risks that China presents and their exposure to those risks, along with expertise in China-related illicit finance typologies.

Money Laundering Threats

China is a higher-threat environment because it is a manufacturing center for

illegal drugs;[9] **suffers from endemic corruption;**[10] **and is leading a source, destination, or transit point for counterfeit goods, illegal wildlife products, and illegally traded weapons.**[11] China also is a leading destination for the proceeds of bank fraud, according to a Financial Crimes Enforcement Network (FinCEN) advisory, one of several advisories that have identified money laundering risks related to China.[12]

- China is the top producer of illicit fentanyl found in the Western Hemisphere.[13] FinCEN on August 21, 2019, warned U.S. banks, money transmitters, online payment systems, and virtual currency exchangers that China-based fentanyl traffickers were exploiting U.S. payment systems to receive money from U.S. distributors and consumers.[14] On the same day, the Treasury Department designated a Chinese fentanyl network.[15]
- In 2017, China and Hong Kong were involved in nearly a third of known instances of counterfeit goods trafficking, and in many cases domestic authorities failed to detect these activities, according to the World Customs Organization.[16] In 2018, U.S. authorities charged 33 people with smuggling nearly $500 million worth of counterfeit luxury goods from China to the United States,[17] and in April 2019 U.S. authorities disrupted a smuggling operation that moved $72 million worth of counterfeit mobile phone parts.[18]
- Corrupt and opaque business practices abound in China's trillion-dollar[19] Belt and Road Initiative (BRI) and are escalating corruption and bribery concerns in vulnerable and developing economies throughout Asia.[20,21,22] Beyond the BRI, China's lack of foreign bribery enforcement[23] and Chinese companies' and state-owned entities' opaque business practices escalate corruption threats in all of the areas where they operate.[24,25,26] A senior U.S. diplomat in April said that Chinese economic engagement in Latin America and the Caribbean has enabled corruption and eroded good governance.[27]

Sanctions Threats

China presents a very high sanctions risk because sanctions evaders from jurisdictions such as Iran and North Korea exploit Chinese markets and many Chinese companies do not have sufficient compliance programs in place to mitigate such risks. This risk is compounded by Chinese government support for regimes sanctioned by the United Nations (UN) and the United States as well as allegations that major Chinese companies have been directly and willingly involved in sanctions evasion activity,[28] including misleading financial institutions about their exposure.[29]

- Sanctioned persons have entered global supply chains by infiltrating Chinese markets, according to U.S. authorities.[30] In one case, North Korean-made products were shipped to China and subsequently re-exported to the United States by a U.S. cosmetics firm. In the enforcement notice, the Treasury Department said that companies face higher sanctions risks when sourcing products from China and should conduct full-spectrum supply chain due diligence.[31]

- Three of China's largest banks—all wholly or partly government-owned—are implicated in a Justice Department investigation of North Korea-related transactions that were allegedly processed through the U.S. financial system, according to filings in a U.S. court.[32] North Korean diplomats have used Chinese shell companies and Chinese banks to transfer funds, and North Korean banks have maintained a large footprint in China, according to the UN.[33]

- In 2018, leading Chinese telecommunications equipment manufacturer ZTE settled with the U.S. Commerce Department for re-exporting U.S. goods to Iran in violation of U.S. laws, as well as repeatedly lying to U.S. regulators and law enforcement authorities.[34] Huawei, another Chinese telecommunications company, is alleged to have engaged in similar activity, and its chief financial officer was indicted on charges of making false statements to banks about Huawei's operations in Iran.[35]

Illicit Finance Vulnerabilities

Weaknesses in China's AML/CFT regime leave the Chinese financial system vulnerable to exploitation by illicit actors and exacerbate the risks that China poses to foreign banks and corporations. In April 2019, a FATF assessment team found that China had low effectiveness in implementing illicit finance safeguards and sanctions targeting terrorist financing and proliferation financing.[36]

- FATF said that China's national risk assessment failed to discuss how the proceeds of crime are laundered.[37] FATF also said that Chinese financial institutions have an insufficient understanding of money laundering and terrorist financing risks, which could expose their correspondent partners to elevated risk.[38]

- The controls that Chinese financial institutions apply "are generally not commensurate with their risks," according to FATF.[39] Mitigating measures were mostly focused on customer identification and transaction monitoring, according to FATF.[40] FATF found that financial institutions' customer due diligence (CDD) measures were generally ineffective, again placing a burden on partner financial institutions to manage the risks of their customer's customers.[41]

- China does not implement UN sanctions targeting terrorist financing and proliferation financing effectively because its sanctions prohibitions do not apply to all persons, because many types of assets cannot be practically frozen, and because China does not circulate new UN resolutions in a timely manner, according to FATF.[42]

China's economy also has structural vulnerabilities that illicit actors can exploit to launder money and evade sanctions. China imposes a $50,000 per year quota on outbound foreign exchange transactions,[43] and people in China have created underground banking channels to circumvent capital controls and complete payments through the international financial system.[44,45] Press reporting[46] suggests that the Chinese underground banking system is deeply embedded in the international financial system.

- FATF found that China's underground financial sector has broad international connections.[47] China's national risk assessment determined that the underground financial sector facilitates "the movement of a significant amount of illicit proceeds" while also facilitating remittances, overseas cash withdrawals with banks cards, foreign exchange, and point-of-service cash withdrawals, according to FATF.[48]

- Chinese authorities claimed that underground banks do not have direct links to the formal financial system but conceded that it was possible that underground banks illegally used financial institutions' settlement networks in conducting their activities, according to FATF.[49] Some underground bankers, who often operate cash-intensive businesses to provide cover, maintain hundreds of bank accounts to facilitate their activities and also settle accounts by conducting parallel transactions in China and abroad, according to Western press reporting.[50]

- The underground banking channel is inherently non-transparent because it is facilitating money flows that are prohibited by Chinese law.[51] The lack of transparency impacts financial institutions both inside and outside of China, because transactions conducted by underground bankers almost certainly fail to include information about the true senders or beneficiaries of funds, judging from press reporting.[52]

Global Exposure

China exposes the rest of the world to its illicit finance threats and vulnerabilities through financial connections that it has established to support its export-driven economy and foreign investment. Illicit actors often look to conceal the proceeds of crime within trade and investment corridors with adequate licit volume to avoid detection, making exposure to even legitimate Chinese trade and investment a factor in considering illicit financial risk and making China's expanding role in global trade an important driver of illicit finance risk for its trade partners.

- China is the world's leading exporter, with $2.3 trillion worth of exports in 2017, according to World Bank data.[53] In 2017, China's exports to more than 100 countries topped $1 billion; in 2007, China's exports to just 75 countries topped $1 billion, according to World Bank data.[54] This expansion in China's trade footprint is proportional to its trade partners' growing exposure to illicit finance risks including trade based money laundering, sanctions evasion, and shipping or transshipment-related risks.
- China's net foreign direct investment outflows exceeded $100 billion each year from 2014 to 2017, according to IMF data.[55] During the past five years, authorities and investigative journalists in Australia,[56,57,58] Canada,[59] and the United States[60,61] have raised concerns that Chinese investors are exploiting their real estate markets to conceal illicit proceeds. In Canada, a confidential police intelligence study concluded that Chinese organized crime groups laundered as much as $1 billion through high-end Vancouver real estate in 2016 alone.[62]
- Chinese banks are rapidly expanding their global presence, in part to support Chinese government policy initiatives, according to trade press reporting.[63] Recent branch expansion is closely tracking the BRI.[64]

Managing China-Related Risk

Financial institutions and multinational corporations should consider implementing specialized controls to manage their China-related risk that are commensurate with specific direct and indirect exposure to China, with China-specific segmentation for both customer due diligence and transaction monitoring. Some Chinese officials, banks, and companies have demonstrated an inability to adequately mitigate illicit finance risks, heightening the risk for foreign financial institutions and placing a heavy compliance burden on institutions providing financial services to or doing business with Chinese entities.

- Financial institutions and corporations outside of China should design their counter-illicit finance, sanctions, and supply chain risk management programs to apply additional scrutiny to relationships and transactions that expose them to illicit finance risks emanating from China. Developing China-specific customer segmentation and monitoring scenarios would help financial institutions effectively deploy limited resources against a high volume of China-related transactions.

- Financial institutions and multinational corporations should consider establishing teams that specialize in diagnosing exposure and managing direct and intermediated illicit finance risks related to China, to ensure that their programs account for all of the China-related red flags that regulators have issued, and to develop expertise in China-related illicit finance typologies, especially Chinese underground banking.

The nature of the risk emanating from China—which is closely linked to important and substantial licit economic relationships—signals a need for banks and multinational corporations to change the way that they approach the geographic risk ratings they use to assess customers, transactions, and deals.

- Banks and multinational companies establishing their geographic risk ratings should consider not just the degree of illicit financing risk associated with a high-risk jurisdiction—the typical focus of risk ratings—but also the particular characteristics of such jurisdictional risk.

- Moreover, banks and multinational companies should give greater consideration toward the extent and ways in which their businesses and home jurisdictions are exposed through trade and investment flows to the high-risk jurisdiction. These considerations will inform a more effective approach in designing and applying tailored risk mitigation controls.

Endnotes

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