

Security Dimensions of Illicit Financial Flows

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Although the role of illicit financial flows (IFFs) in hindering economic development is well understood, their implications for security—both national and global—have not received enough attention. IFFs are an important manifestation of “deviant globalization.”¹ Just as the free movement of capital is crucial to the international financial and trade systems, the cross-border movement of capital is important for a variety of illicit activities that undermine security.² IFFs, for instance, help make crime pay: they aid those associated with transnational organized crime to move and spend their ill-gotten gains. They are also integral to the financing of terrorist and insurgent groups, which threaten domestic and foreign security, imperil civilians and military personnel, and endanger U.S. allies and national interests. Moreover, the ability to launder, stash, and spend funds overseas enables corruption, which can destabilize countries and regions. IFFs can also undermine security forces, rendering them less able to respond to threats of criminality and terrorism.

The U.S. government and other actors can implement policies to help mitigate IFFs and the crime, terrorism, insurgency, and corruption they facilitate. These policies will not eliminate security threats in the United States or abroad, but they can assist law enforcement and the military to meet those threats and reduce the leverage of actors that foster state fragility. IFFs should be recognized as contributing to threats to the homeland, and national security agencies should make countering IFFs—by using national and global instruments—a priority.

ILLICIT FINANCIAL FLOWS MAKE CRIME PAY

Joaquin Guzman has been described as an “obsessive entrepreneur with a proclivity for micromanagement,” perhaps not a surprise given that, in 2012, he ran a business with an estimated \$3 billion in revenue, on par with Netflix. His global logistic network rivaled that of Amazon or United Parcel Service (UPS), and his business controlled between 40 and 60 percent of the U.S. market for his products. Guzman—better known as El Chapo—headed the Sinaloa Cartel, a narcotics trafficking organization that continues to operate in as many as fifty countries.³

Moving criminal proceeds across such a large network is not easy. The Sinaloa Cartel and other illicit groups need to manage funds from customers, retailers, and wholesalers. Cartel leaders need to pay bribes to lower operating risks, reinvest profits into the cartel business, and ensure that all components of the supply chain—from coca and opium poppy growers to complex logistics networks—are funded, all while maintaining the lifestyles to which they and their families are accustomed. These activities involve substantial IFFs: if profits cannot be transferred throughout the supply chain to incentivize and pay for this criminal network, it will cease to function. American drug users spend about \$100 billion on cocaine, heroin, marijuana, and methamphetamines each year, and the U.S. banking system is “at the center” of the money laundering efforts of Sinaloa and other cartels.⁴

HSBC, for example, with its lax money laundering controls, allowed \$881 million in drug proceeds to be laundered over five years; a deferred prosecution agreement for the company ended in 2017.⁵ In February 2018, the U.S. government fined the Dutch financial services company Rabobank for laundering millions and then obstructing the subsequent investigation.⁶ In addition to the high-volume transfers through U.S. banks, illicit funds flow through alternate means such as trade-based money laundering and bulk cash smuggling.⁷

Although it would be impossible to eliminate all IFFs associated with narcotics supply chains, a thought experiment of what would happen if IFFs were eliminated highlights their importance. Without IFFs, international narcotics supply chains would soon break down, forcing drug suppliers into largely domestic production. Some narcotics could be produced more intensively for domestic consumption, as legalized marijuana production in the United States has demonstrated. Other narcotics, however, would be difficult to produce in quantities sufficient to meet the large U.S. demand without attracting attention of law enforcement. It would be difficult, for instance, to grow the huge fields of opium poppies needed to supply the growing U.S. market. Likewise, the coca plant can only grow in specific climates and altitudes—hence the critical role of growing regions in South America. Some Americans, faced with shortages or higher prices, would seek substitutes for their drugs of choice, just as those addicted to pharmaceutical opioids often switch to opium and fentanyl, which are cheaper and easier to buy. Overall, though, higher prices and the increased risks of drug production would likely decrease the number of new addicts, decrease the crime associated with international narcotics supply chains into the United States, and make it easier for the United States to manage the public health aspects of drug addiction. Combating IFFs associated with drug trafficking, then, is a worthwhile endeavor.

A decrease in IFFs would also decrease the rents available from drug activity globally. If the money generated from U.S. drug consumers could no longer make it back to international criminal networks abroad, narcotics supply chains through Central America to the United States would break down. Given that policies against IFFs associated with narcotics trafficking are also effective against other international criminal activity—such as human smuggling, oil bunkering, illegal mining, and financial flows associated with large-scale corruption and tax evasion—implementation of these anti-IFF policies would make transnational crime a more manageable security issue for the United States and other states in the hemisphere.

ILLICIT FINANCIAL FLOWS FACILITATE TERRORISM AND INSURGENCY

The world's largest terrorist and insurgent groups often rely on diversified and far-flung illicit financial operations. While individual terrorist acts are sometimes inexpensive, extended terrorist and insurgent campaigns require substantial funding and, often, IFFs. Large-scale terrorist and insurgent organizations need weapons, personnel, basic provisions, and logistical networks—all of which require financial resources.

Hezbollah, for example, with operations in Lebanon, Syria, and Iraq, makes substantial and well-documented use of IFFs.⁸ The Sentry, an investigative organization, reported that BGFIBank, based in the Democratic Republic of Congo (DRC), had facilitated U.S. dollar-denominated transactions for well-known Hezbollah financier Kassim Tajideen and companies associated with him. This facilitation of terrorist finance occurred despite employees' written warnings about Tajideen's Hezbollah

ties to the bank's CEO—and adopted brother of DRC President Joseph Kabila—Francis Selemani Mtwale. The bank continued to move money for Tajideen and even requested that the U.S. Office of Foreign Assets Control unblock transactions after other banks refused to process them. The Sentry speculates that deals such as these could be linked to DRC's continuing instability, as Kabila seeks to remain in power through relationships with illicit actors.⁹

The self-proclaimed Islamic State has also used IFFs, stashing millions of dollars as its territory has shrunk in recent years. In March 2017, the Islamic State mandated the use of its own currency. As residents exchanged Syrian pounds, U.S. dollars, and other currencies for the new currency, the Islamic State moved a share of those funds out of its territory using currency exchanges and the *hawala* system.¹⁰ One Iraqi legislator estimated that the Islamic State had smuggled \$400 million out of its former territory as it retreated.¹¹ The Islamic State could still siphon funds from abroad via extortion, smuggling, and other black-market activities. The availability of cross-border illicit transfer will likely both extend the life of the Islamic State and permit its network to carry out terrorist activities after its demise.

IFFs are often at the core of conflict networks. Indeed, many conflicts begin and persist because their supporting criminal patronage networks can be maintained. One example is the conflict in South Sudan, where warlords have used IFFs to facilitate both lavish lifestyles and ongoing conflict as they seek to capture the rents from the country's resource wealth and foreign assistance.¹² Recognition of the role that corruption, associated IFFs, and personal enrichment play in the South Sudanese conflict has principally driven UN sanctions against warlords in the region.

ILLICIT FINANCIAL FLOWS ENABLE LARGE-SCALE CORRUPTION

IFFs are linked to corruption (the abuse of entrusted power for private gain), which also has security implications.¹³ The World Bank estimates that individuals and businesses pay \$1.5 trillion in bribes each year, about 2 percent of global gross domestic product, or ten times the value of overseas development assistance.¹⁴ IFFs are involved in both the payment of large-scale bribes and the laundering of proceeds.

Corruption destabilizes countries. A 2015 study by the Institute for Economics and Peace (IEP) found that countries exhibit a “tipping point”—once a certain degree of corruption is reached, small increases in corruption lead to large decreases in peace.¹⁵ Seven out of the ten lowest scoring countries on Transparency International's 2016 Corruption Perceptions Index were also among the ten least peaceful countries on the IEP's 2017 Global Peace Index.¹⁶ Sarah Chayes, a senior fellow at the Carnegie Endowment for International Peace, has assessed that corruption is strongly correlated with state failure and with political instability, making a credible case for corruption as an under-recognized threat to U.S. national security.¹⁷

Natural resource-rich states in particular are associated with a higher likelihood of onset and longer duration of civil war, and many scholars have highlighted links between corruption and conflict dynamics. The availability of various natural resources—including petroleum, diamonds, and other nonfuel minerals, timber, and goods like coca leaves—seems to explain the prevalence of conflict.¹⁸ Scholars explain this correlation variously.

Some scholars suggest that natural resource wealth makes governments administratively weaker and thus less able to prevent rebellions. Others focus on insurgency, arguing that natural resources increase the value of capturing the state, thereby encouraging conflict over prospective spoils. Insur-

gents, especially those in ethnically or otherwise marginalized areas, could seek independence in order to control locally generated revenues. Stanford University political scientist Jeremy Weinstein has argued that rebel groups with easy access to financing through natural resources or external patrons tend to commit higher levels of indiscriminate violence whereas those in more resource-poor situations carry out fewer abuses and are more targeted with their violence.¹⁹ Still others assert that conflict and corruption are deeply intertwined in certain types of fragile states.²⁰

IFFs are integral to these conflict dynamics. Predatory states, in various forms, certainly existed before contemporary financial globalization and associated illicit flows. IFFs, however, expand the rewards that violence entrepreneurs and their supporters can reap and allow those assets to be stored in offshore havens, accessible on short notice. Predatory states and the various warlords, terrorists, and insurgents who fight those states often highly rely on IFFs from natural resources sold overseas. Warlord states in Africa often feature patronage systems organized around rulers' control over resources and the rents they provide.²¹ Whereas warlords in previous eras fought over grazing or agricultural land, their contemporary counterparts seek to control the oil underneath that land, bringing in multinational firms to extract and export that oil while providing a portion of the rents to the ruler. The same goes for resources such as alluvial diamonds or timber, which can be exported using the international trading system. The rents from these resource transactions no longer need to remain in the vicinity of the bandit ruler but can be stored or spent safely in foreign havens—in the form of real estate, art, and cash—via anonymous shell companies.

The Kabul Bank corruption scandal in Afghanistan underscores the links among IFFs, corruption, and security. In March 2004, the Afghan Central Bank granted Kabul Bank the first post-Taliban commercial bank license for Afghanistan's largest *hawala* operator, Sher Khan Farnood. With the license, Farnood's older *hawala* activities soon became entangled with what would become the largest bank in Afghanistan.²² Kabul Bank was also linked to another *hawala*, the New Ansari Money Exchange. All of this made for a convenient one-stop shop for anyone seeking to move money into or out of Afghanistan through bulk cash smuggling, legitimate banking, *hawala*, trade-based money laundering, gold and minerals smuggling, or any combination of these. Customers of the various enterprises included legitimate nongovernmental organizations and businesses as well as illicit actors such as narcotics traffickers, corrupt politicians, and even the Taliban.²³

The bank's insolvency in 2011 illuminated the links among IFFs, Kabul Bank, and the larger conflict, and threatened to erode Afghanistan's tenuous political stability. In the final accounting, over 90 percent of Kabul Bank's loan book—\$861 million—went to nineteen interrelated parties, including the brother of then President Hamid Karzai and close relatives of then First Vice President Mohammad Qasim Fahim. Revelations of these interest-free insider loans undermined the shaky financial system and threatened to lead to larger social unrest. The scandal also caused foreign donors to withhold aid payments and led to delays in disbursements of the Afghan Reconstruction Trust Fund, threatening World Bank projects in the country.²⁴ The scandal threatened the country's security sector as well. Afghan army salaries are paid by the U.S. government, mostly via electronic payments through Kabul Bank into individual soldiers'—and some police personnel's—bank accounts. Closure of the bank, avoided thanks to a bailout, would have meant both the loss of soldiers' savings in those accounts and the logistic means to pay them. The Afghan counterinsurgency campaign had rested on the idea that the United States and the North Atlantic Treaty Organization (NATO) would help build a legitimate Afghan government able and willing to protect its citizens and deliver services. The Kabul Bank scandal called into question the efficacy of the entire strategy.²⁵

Links among IFFs, corruption, state fragility, and conflict are apparent in many other settings. For instance, in Venezuela, IFFs linked to corruption, petroleum, and narcotics trafficking have contributed to widespread impoverishment and significant rises in crime, social upheaval, and refugee outflows.

CORRUPTION AND ILLICIT FINANCIAL FLOWS AS FOREIGN POLICY TOOLS

The links among IFFs, corruption, and national security are even more important given that some states export corruption as a means of illegitimately influencing and weakening other states.²⁶ IFFs play a critical enabling role.

Russia's use of corruption as an aspect of its foreign policy strategy provides the most salient example of this phenomenon. In *The Kremlin Playbook*, researchers at the Center for Strategic and International Studies show how "Russia has cultivated an opaque network of patronage" through five case studies: Bulgaria, Hungary, Latvia, Serbia, and Slovakia.²⁷ Russia uses the promise of "perpetual enrichment" and Russian state resources to "capture" critical individuals within states, who then spread this promise to other individuals, in what the authors call a contagion.²⁸ Much of this strategy is accomplished through the use of IFFs.²⁹ Russian interests could, for example, buy out large foreign companies that make substantial donations to political parties, or they could provide financial support to critical political or economic elites, often through offshore investments and anonymous companies.³⁰ Over time, the affected countries' economies and institutions become so compromised that the very state institutions created to fight back corruption are disabled. This also provides Russian agents opportunities for blackmail: captured governments risk collapse if their corruption is exposed. Corruption scandals, meanwhile, erode public trust in mainstream politics and politicians.³¹ International measures to combat IFFs increase the difficulty of exporting corruption and limit its use as a form of statecraft.

ILLICIT FINANCIAL FLOWS AND SECURITY INSTITUTIONS

IFFs facilitate global bads, such as corruption, crime, and terrorism. They can also undermine the security sectors that are supposed to combat them. Nigeria provides one example. In 2015, Sambo Dasuki, former national security advisor to the president, was charged with three dozen counts of money laundering and breach of trust. Dasuki was alleged to have withdrawn over \$2 billion from the Central Bank of Nigeria via phantom contracts—contracts created solely for the purposes of corruption, with no actual business activity toward fulfillment. The funds, ostensibly for the purchase of twelve helicopters, four fighter jets, and ammunition to fight Boko Haram, disappeared. At least part of that money was allegedly diverted to the failed bid to reelect Goodluck Jonathan.³² This was not the first time that Nigerian national security funds ended up being moved illegally. A U.S. Department of Justice complaint against former President Sani Abacha documents how, in the 1990s, Abacha and his colleagues, including the National Security Advisor Ismaila Gwarzo, withdrew funds—again, ostensibly for national security purposes—from the Central Bank of Nigeria for unspecified emergencies and sent those funds overseas, including into U.S. and British financial institutions.³³

Corruption, criminality, and associated IFFs undermine the ability of security forces to work effectively, as money earmarked for equipment, personnel, training, and other essentials is siphoned overseas. The corruption that leads to these large financial flows also provides incentives for government officials to purchase equipment as kickbacks rather than for national security needs. Corruption can damage esprit de corps, as soldiers see their military leaders using the defense budget for personal benefit rather than for the good of the troops and the nation. And corruption weakens the bond between the security sector and the citizens, as citizens come to see the sector as corrupt and even predatory.

Although many countries allocate large proportions of their budgets to security sector spending, the sector often receives little political or financial oversight: a prescription for grand corruption. Transparency International's Government Defense Anticorruption Index is illuminating in this regard. Of the 118 countries that Transparency International assessed in 2015, sixty-three were at high or critical risk of corruption in their defense sectors. Many countries do not allow meaningful parliamentary oversight of their defense sector. Even in NATO, only five of the thirty-three member and partner states allowed parliamentary committees unimpeded powers to review secret spending on defense and security. Only two countries—New Zealand and the United Kingdom—were listed in band A for having the lowest risk for corruption in their defense sectors (the United States was placed in band B).³⁴

RECOMMENDATIONS

Given the important links between IFFs and a host of national security issues, the U.S. government should take action to mitigate these threats.

Close U.S. Money Laundering Loopholes

The United States is among the worst violators when it comes to ease of money laundering and tax avoidance. The Tax Justice Network ranked the country second (only after Switzerland) in its 2018 Financial Secrecy Index, which measures a combination of financial secrecy and the scale of offshore financial activities.³⁵ Likewise, the Financial Action Task Force (FATF), the international body that sets standards for anti-money laundering and combating the financing of terrorism (AML/CFT), noted in December 2016 that the U.S. regulatory framework does not hold institutions and professionals such as lawyers, investment advisors, real estate agents, and trust and company service providers to minimum international standards.³⁶ The United States could facilitate even more IFFs going forward. With the European Union cracking down on money laundering by implementing public registries of beneficial ownership of companies and trusts, and the United Kingdom forcing similar rules on its overseas territories, the United States will be one of the last major Western financial centers that permits anonymous shell companies and trusts. Priorities for closing off these loopholes include the following:

Pass beneficial ownership legislation. Four bipartisan bills that require companies to disclose their beneficial owner(s) when incorporating and to keep those registers up to date are currently in the Congress. One, which has both House and Senate versions, is the Corporate Transparency Act of 2017 (H.R. 3089/S. 1717). Another is the True Incorporation Transparency for Law Enforcement Act.

Parts of H.R. 3089 on beneficial ownership had also been in the Counter Terrorism and Illicit Finance Act; the beneficial ownership language in the bill is currently being renegotiated in committee.³⁷ These bills restrict beneficial ownership registries to law enforcement and banks rather than create public registries. These bills already have the support of major banks, the Fraternal Order of Police, other law enforcement advocacy groups, and major investors. They serve as a starting point for beneficial ownership legislation.

Ensure high levels of due diligence. The U.S. Department of the Treasury should ensure that investment advisors, bank holding companies, security broker-dealers, lawyers, accountants, and trust and company service providers comply with the anti-money laundering standards and due diligence to which banks are held. The Treasury Department should do this by lifting the 2002 temporary exemption to the USA Patriot Act, which grants those involved with real estate deals a waiver from anti-money laundering and due diligence checks. Also, the department's temporary order requiring title insurance companies in seven cities to provide beneficial ownership information for all-cash, high-end real estate purchases, due to expire in September 2018, should be made permanent and cover the entire United States.³⁸

Implement Stronger Standards for Security Assistance

The United States should press for implementation of stronger transparency, accountability, and counter-corruption standards for security assistance to other countries. IFFs in security sectors have especially pernicious effects, as these allow for the breakdown of the rule of law, provide impunity for some actors, and incentivize security sector actors and state leaders at times to value insecurity and authoritarianism over democratic reforms, human rights, free media, and open markets. The following efforts should be undertaken:

- The United States should encourage countries to develop and undertake voluntary standards for security sector integrity, especially in procurement. The standards should commit participants to maintain the maximum degree of openness and oversight by parliaments, the media, and citizens, and commit to keeping only the most crucial national security information secret. Mechanisms for at least some parliamentary oversight of secret budgets should also be established. The United States, where select members of critical congressional committees have the ability to review classified budgets and are briefed on classified programs, is an important example.
- Countries should limit secrecy in security sector-related contracting to items and services crucial to national security. The vast majority of contracts should follow the Open Contracting Global Principles and associated data standards, which seek to make government procurement contracting more transparent, fair, and competitive. All government procurement contracts, especially those associated with the security sector, should require contractors and subcontractors to declare their beneficial owners and should include corruption clauses to allow for contract termination upon evidence of corruption. These contracts should also include clawback clauses, which allow money that benefited terrorist, criminal, or corrupt purposes to be paid back to the host government. Governments should establish compliance offices to vet contractors and subcontractors.
- Countries should improve reporting and auditing of security sector spending, especially enabling parliamentary and civil society oversight of security-related budgets. Ukraine's Independent De-

fense Anti-Corruption Committee and the upcoming audit of the country's main export firm, Ukroboronprom, can be models for improving security sector oversight in highly corrupt and conflict-ridden environments.³⁹

- The United States, along with other major exporters of security sector goods and services, should increase oversight of and restrictions on exports to countries considered by the World Bank and Transparency International to be highly corrupt and at high risk for corrupt activities.

IFFs underpin a variety of global bads that threaten U.S. interests at home and abroad. A number of priority issues for the United States—including narcotics supply chains, terrorism, insurgency, and state fragility—are facilitated by these flows. Strategies for fighting these threats will be undermined unless combating IFFs becomes a central element of U.S. security policy.

ENDNOTES

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