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Written Statement for the Hearing On

"Trading with the Enemy: Trade-Based Money Laundering is the Growth Industry in Terror Finance"

Before the Task Force to Investigate Terrorism Financing

Of the House Financial Services Committee

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Chairman Fitzpatrick, Ranking Member Lynch and members of the Task Force to Investigate Terrorism Financing, thank you for the opportunity to testify today. It is an honor for me to be here.

Not long after the September 11 attacks, I had a conversation with a Pakistani entrepreneur. This businessman could charitably be described as being involved in international grey markets and illicit finance. We discussed many of the subjects addressed in this hearing including trade-based money laundering, terror finance, value transfer, hawala, fictitious invoicing, and counter-valuation. At the end of the discussion, he looked at me and said, "Mr. John, don't you know that your adversaries are transferring money and value right under your noses? But the West doesn't see it. Your enemies are laughing at you."

The conversation made a profound impact on me. I knew he was right. At the time of the conversation, the U.S. government and the international community had not focused attention or resources on the misuse of international trade to launder money, transfer value, avoid taxes, commit commercial fraud, and finance terror. It was completely under our radar screen. Our adversaries − terrorists, criminals, kleptocrats, and fraudsters − were operating in these areas with almost total impunity. And unfortunately, many years after that conversation and the tremendous expenditure of resources to counter illicit finance, trade-based money laundering and value transfer are still not recognized as significant threats. Perhaps as the Pakistani businessman inferred, it is because the subterfuges are "hiding in plain sight."

The Financial Action Task Force (FATF) has declared that there are three broad categories for the purpose of hiding illicit funds and introducing them into the formal economy. The first is via the use of financial institutions; the second is to physically smuggle bulk cash from one country or jurisdiction to another; and the third is the transfer of goods via trade.[i] The United States and the international community have devoted attention, countermeasures, and resources to the first two categories. Money laundering via trade has for the most part been ignored.

Trade-based money laundering and value transfer (TBML) is a very broad topic. FATF defines TBML as "the process of disguising the proceeds of crime and moving *value* through the use of trade transactions in an attempt to legitimize their illicit origins."[ii] The key word in the definition is *value.*

Magnitude of the Problem

There are no official estimates on the magnitude of TBML as a whole. Since the issue impacts national security, law enforcement, and the collection of national revenue it is remarkable that TBML has never been systematically examined by the U.S. government.

I would like to give you just a few examples to demonstrate the enormity of the problem.

Dr. John Zdanowicz, an academic and early pioneer in the field of TBML, examined 2013 U.S. trade data obtained from the U.S. Census Bureau. By examining under-valued exports ($124,116,420,714) and over-valued imports ($94,796,135,280) Dr. Zdanowicz found that $218,912,555,994 was moved out of the United States in the form of value transfer! That figure represents 5.69% of U.S. trade. Examining over-valued exports ($68,332,594,940) and under-valued imports ($272,753,571,621), Dr. Zdanowicz calculates that $341,086,166,561 was moved into the United States! That figure represents 8.87% of U.S. trade in 2013.[iii]

I believe the United States has the most professional and vigorous customs enforcement service in the world. So if almost 6 to 9 percent of our trade is tainted by customs fraud and perhaps trade-based money laundering, what does that mean for the rest of the world, in particular countries with weak governance and high corruption?

By examining other forms of TBML the magnitude of the problem increases further. For example, TBML is also involved with customs fraud, tax evasion, export incentive fraud, VAT fraud, capital flight or the transfer of wealth offshore, evading capital controls, barter trade, underground financial systems such as hawala and the fei-chien – the Chinese "flying money system, the black market peso exchange (BMPE), and commercial trade-based money laundering such as trade diversion, transfer pricing, and abusive trade-misinvoicing.

The amount of trade-misinvoicing is staggering. According to Raymond Baker, the head of Global Financial Integrity (GFI) and a worldwide authority on financial crime, "Trade misinvoicing – a prevalent form of TBML – accounts for nearly 80 percent of all illicit financial outflows that can be measured by using available data."[iv] According to a 2015 study by GFI, "Illicit financial flows from developing and emerging economies surged to $1.1 trillion in 2013." By just focusing on developing economies, cumulative illicit outflows were approximately $7.8 trillion between 2004 and 2013 in the GFI study, the last year for which data are available.[v]

TBML is found in every country in the world – both developed and developing. But the massive transfer of wealth offshore through abusive trade misinvoicing is particularly harmful to countries with weak economies, high corruption, and little adherence to the rule of law. The developmental, human and societal costs are staggering.

Trade-based value transfer has existed long before the advent of modern "Western" banking. In areas where our adversaries operate, trade-based value transfer is part of a way of life. It is part of their culture; a way of doing business. TBML is related to terrorist finance. In just one example of TBML and terrorist financing, a Pakistani madrassa – a fundamentalist Islamic religious school – was linked to radical jihadist groups. The madrassa received large amounts of money from foreign sources. It was engaged in a side business dealing in animal hides. In order to justify the large inflow of funds, the madrassa claimed to sell a large number of hides to foreign customers at grossly inflated prices. This ruse allowed the extremists to "legitimize" the inflow of funds which were then passed to terrorists.[vi]

In addition, trade-based value transfer is often used to provide "counter-valuation" or a way of balancing the books in many global underground financial systems - including some that have been used to finance terror. Trade-based value transfer is found in hawala networks and most other regional "alternative remittance systems."

The World Bank estimates that global remittances through official channels like banks and Western Union will reach $707 billion by 2016. Nobody has reliable estimates of remittances through *unofficial* channels. However, the International Monetary Fund believes, "unrecorded flows through *informal channels* are believed to be at least 50 percent larger than recorded flows."[vii] Thus according to these World Bank and IMF estimates, unofficial remittances could be well over $1 trillion!

Our countermeasures for underground money remitters like hawaladars are not effective. Requirements for registration, licensing, and filing of financial intelligence have all failed – not only in the United States but in other countries where they have been tried. I believe that a systematic examination of TBML and value transfer and their links to underground finance could be the "back door" into hawala and other problematic alternative remittance systems – some used by our terrorist adversaries. Yet the U.S. and the international community have virtually ignored trade's role in underground financial systems.

TBML is also intertwined with the misuse of the Afghan Transit Trade, Iran/Dubai commercial connections, the Tri-Border region in South America, suspect international Lebanese/Hezbollah trading syndicates, non-banked lawless regimes such those in Somalia and Libya, territory controlled by ISIS in Syria and Iraq, and many more. The promotion of international trade transparency could provide clarity for these opaque value transfer systems.

To summarize, the argument can be made that TBML and value transfer, including all its varied forms, is perhaps the largest and most pervasive money laundering methodology in the world. Unfortunately, it is also the least understood, recognized, and enforced. In comparison to the annual volume of tens of trillions of dollars in international general merchandise trade, successful enforcement efforts are practically nil.

How Does TBML Work?

In its primary form, TBML revolves around invoice fraud and associated manipulation of supporting documents. When a buyer and seller work together, the price of goods (or services) can be whatever the parties want it to be. There is no invoice police! As Raymond Baker succinctly notes, "Anything that can be priced can be mispriced. False pricing is done every day, in every country, on a large percentage of import and export transactions. This is the most commonly used technique for generating and transferring dirty money." [viii]

The primary techniques involve invoice fraud and manipulation. They include:

- Over-and-under invoicing of goods and services
- Multiple invoicing of goods and services
- Falsely described goods and services

Other common techniques related to the above include:

- Short shipping: this occurs when the exporter ships fewer goods than the invoiced quantity of goods thus misrepresenting the true value of the goods in the documentation. The effect of this technique is similar to over invoicing.
- Over shipping: the exporter ships more goods than what is invoiced thus misrepresenting the true value of the goods in the documentation. The effect is similar to under invoicing.
- Phantom shipping: No goods are actually shipped. The fraudulent documentation generated is used to justify payment abroad.

Invoice Fraud

Money laundering and value transfer through the over- and-under invoicing of goods and services is a common practice around the world. The key element of this technique is the misrepresentation of trade goods to transfer value between the importer and exporter or settle debts/balance accounts between the trading parties. The shipment (real or fictitious) of goods and the accompanying documentation provide cover for the transfer of money.

First, by under-invoicing goods below their fair market price, an exporter is able to transfer value to an importer while avoiding the scrutiny associated with more direct forms of money transfer. The value the importer receives when selling (directly or indirectly) the goods on the open market is considerably greater than the amount he or she paid the exporter.

For example, Company A located in the United States ships one million widgets worth $2 each to Company B based in Mexico. On the invoice, however, Company A lists the widgets at a price of only $1 each, and the Mexican importer pays the U.S. exporter only $1 million for them. Thus, extra value has been transferred to Mexico, where the importer can sell (directly or indirectly) the widgets on the open market for a total of $2 million. The Mexican company then has several options: it can keep the profits; transfer some of them to a bank account outside the country where the proceeds can be further laundered via layering and integration; share the proceeds with the U.S. exporter (depending on the nature of their relationship); or even transfer them to a criminal organization that may be the power behind the business transactions.

To transfer value in the opposite direction, an exporter can over-invoice goods above their fair market price. In this manner, the exporter receives value from the importer because the latter's payment is higher than the goods' actual value on the open market.

Invoice Manipulation Made Simple!

To move money/value out:

- **Import goods at overvalued prices or export goods at undervalued prices**

To move money/value in:

- **Import goods at undervalued prices or export goods at over-valued prices**

For example, Figure 1[ix] below shows the fluctuating value associated with thousands of refrigerators exported from Country A to Country B via a series of shipments. The darker shade represents the declared value of the refrigerators upon export from Country A, and the light shade represents their declared value upon arrival in Country B. The horizontal line represents the time period over which these shipments occurred. The vertical line represents the value expressed in dollars. In this case the refrigerators were over-invoiced. The export data came from the "shippers export declaration" (SED) that accompanies the shipments. The import data came from the importing country's customs service. Obviously, the declared export price should match the declared import price. (There are some recognized but comparatively small pricing variables. In addition, the quantity and quality of refrigerators should also match - which occurred in this case.) The difference in price between the dark and light shades represents the transfer of value from the importer to the exporter. In this case, the transfer represented the proceeds of narcotics trafficking.

At the end of the chart the shaded colors start to converge. The colors or values between imports and exports begin to match because data was compared, anomalies noted, and joint enforcement action taken by the two countries involved. Trade transparency was achieved. The comparative stability at the end of the chart reflects true market conditions.

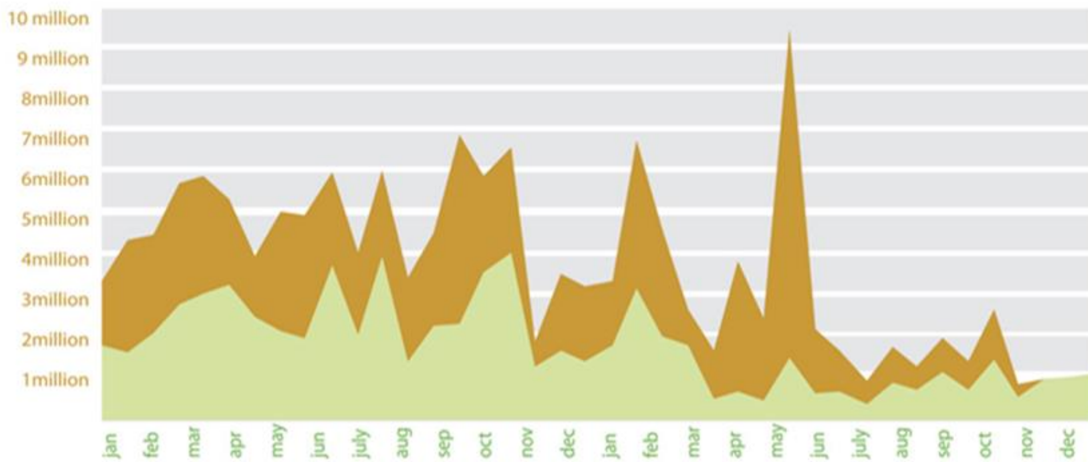

Figure 1

There are incredible examples of trade-mispricing. For example, Dr. John Zdanowicz conducted a study analyzing U.S. trade data.[x] He found plastic buckets from the Czech Republic imported with the declared price of $972 per bucket! Toilet tissue from China is imported at the price of over $4,000 per kilogram. Bulldozers are being shipped to Colombia at $1.74 each! Of course, there are various reasons why the prices could be abnormal. For example, there could simply be a data "input" or "classification" error. However, recalling the above explanation of over-and-under invoicing, the abnormal prices could also represent attempts to transfer value in or out of the United States in the form of trade goods. At the very least, the prices should be considered suspicious. Only analysis and investigation will reveal the true reasons for such large discrepancies between market price and declared price.

Countermeasures – Data, Analytics, and Trade Transparency

Despite the enormity of TBML and the challenges briefly outlined above, I am hopeful. The reason for my optimism is that *theoretically* international trade transparency can be achieved. As opposed to other money laundering methodologies (for example, bulk cash smuggling) a growing volume of precise data exists that enable analysts and criminal investigators to follow the value transfer trails.

Over the last few years there has been an explosion in both government and commercial data related to trade. Overlaying financial intelligence, law enforcement and customs data, travel data, commercial records, shipping data, etc. further increases transparency and facilitates more clarity. Simultaneously, there has been incredible progress in advanced analytics. I am particularly excited about "predictive analytics" which helps analysts and investigators spot patterns, methods, and trends as well as prioritize investigative leads.

Time and space do not allow me to elaborate on how trade and associated data is produced and analyzed. Other witnesses, including my friend Lou Bock, the "godfather" of TBML, will elaborate on this in their remarks.

In order to champion trade transparency, in 2004 the United States government adopted a proposal Lou and I advanced and created the world's first trade transparency unit (TTU). It is located within Homeland Security Investigations (HSI). (For further information see the TTU website at: https://www.ice.gov/trade-transparency) The initiative seeks to identify global TBML trends and conduct ongoing analysis of trade data provided through partnerships with other countries because one of the most effective ways to identify instances and patterns of TBML is through the exchange and subsequent analysis of trade data for anomalies that would only be apparent by examining both sides of a trade transaction.

A TTU is formed when HSI and any of the United States trading partners agree to exchange trade data for the purpose of identifying comparison and analysis. To help analyze the data, the HSI has developed a specialized computer system. Containing both domestic and foreign trade data, the system allows users to see both sides of a trade transaction, making it transparent to both countries. As in the example of refrigerators in Figure 1 above, TTUs can easily identify trade anomalies that could be indicative of customs fraud, TBML, contraband smuggling, tax evasion, and even underground finance. Of course, investigations are still required. This investigative tool has been proven to be effective. Since the creation of the domestic and international TTU initiative, more than $1 billion has been seized.[xi]

Another reason I am optimistic about the long-term prospects of achieving trade transparency is that it is a revenue enhancer. By systematically cracking down on various forms of customs fraud, hundreds of billions in dollars of lost revenue can be returned to cash-starved governments around the world. This could be particularly helpful in parts of the world where our adversaries operate and weak governments are starved for revenue. In cases where corruption is rife, effective trade analysis can be accomplished outside of the country. I have found that many times when I travel to the developing world and talk about the importance of anti-money laundering and counter-terrorist finance, the reception is sometimes cool. However, when I explain to the officials how much revenue they can obtain by cracking down on customs fraud they become very interested. In other words, the carrot of empowering our partners to strive for trade transparency and increased revenue can be much more effective than the stick of heavy handed measures that have proved unsuccessful.

Recommendations

1. As noted, I believe TBML could be the largest and most pervasive money laundering methodology in the world. However, we do not know for certain because the issue has never been systematically examined. This is even more surprising in the United States because annually we are possibly losing billions of dollars in lost taxes due to trade-mispricing alone. While not necessarily true for all money laundering methodologies, trade generates data. I believe it is possible for economists, statisticians, and analysts to come up with a fairly accurate estimate of the overall magnitude of global TBML and value transfer. Narrowing it down to specific problematic countries is easier still.

I suggest this Task Force urge the Department of Treasury's Office of Intelligence and Analysis (OIA) to at least examine U.S. related data and come up with an official estimate for the amount of TBML *in all its varied forms* that impacts the U.S. A generally accepted estimate of the magnitude of TBML is important for a number of reasons: a.) It will provide clarity; b). It will focus attention on the issue; c.) From an enforcement perspective, the supporting analysis should provide both excellent insight into specific areas where criminals are vulnerable and promising opportunities for targeting; and d.) A systematic crack down on TBML and customs fraud will translate into enormous revenue gain.

2. In the world of anti-money laundering/counter-terrorist finance (AML/CFT) enforcement, the FATF makes things happen. The FATF recognizes TBML is a huge concern. There is a special FATF typology report on TBML. However, in 2012 when the current FATF recommendations were reviewed and promulgated, TBML was not specifically addressed. It is past time this is done. I suggest the Task Force contact the U.S. Department of Treasury (which heads the U.S. FATF delegation) and urge that the U.S. introduce a resolution calling for the misuse of trade to launder money and transfer value be examined as a possible new FATF recommendation.

3. HSI continues to expand the network of operational TTUs, which now includes Argentina, Australia, Colombia, Dominican Republic, Ecuador, Guatemala, Mexico, Panama, Paraguay, Peru and Philippines. As part of the TTU initiative, HSI provides equipment and increased operational support to these TTU partners to ensure the network's successful development. I believe the TTU concept should be further developed and expanded. In the "next frontier of international money laundering enforcement," I believe a global TTU network should be created that is somewhat analogous to the Egmont Group of Financial Intelligence Units. Two wonderful aspects of this program are that data already exists and trade transparency

is actually a net revenue enhancer – not only for the United States but for partner countries. I urge Congress to create a separate line item for the HSI TTU initiative so as to promote its expansion. Our TTU has been raided of funds and personnel. Without resources, its functional existence is in jeopardy.

I also believe the concept of trade transparency should be built into the US trade agenda. For example, the new Trans-Pacific Partnership (TPP) is set to lower or eliminate tariffs on everything from imported Japanese cars to New Zealand lamb, while opening two-fifths of the global economy to easier trade in services and electronic commerce.[xii] I don't have a position on the pros and cons of the TPP. But the volume of increased trade will provide additional opportunities for trade-based value transfer and money laundering. I suggest we help protect abuse by insuring that every TPP signatory country establish a TTU and share appropriate targeted trade data to spot anomalies that could be indicative of trade fraud at best and TBML at worst.

4. The misuse of trade is a law enforcement issue – not just a customs issue. Unfortunately, I have first-hand experience that there is almost a total lack of knowledge at the federal, state, and local law enforcement levels regarding TBML and the importance of following the value transfer trail. Even though I can demonstrate how TBML affects state and local law enforcement, most often the consensus opinion is, "Trade is a customs issue. It doesn't concern me or my department."

Yet it is precisely because law enforcement officers are on the front lines in their communities and know their operating environment well, they should notice if a local business or commercial activity does not make market or economic sense. For example, a normal business should not remain in operation for long with sporadic commercial activity or when consistently selling goods far above or below market norms. Numerous businesses in the U.S. and elsewhere are involved at the local level in TBML schemes and deal with goods that are frequently manipulated to transfer value. Businesses involved with the black market peso exchange (BMPE) – large and small - are found throughout the United States. Underground financial networks such as hawala and fei-chien are found in local communities and they often depend on trade and local business networks.

Accordingly, I urge my state and local law enforcement colleagues to become more familiar with issues surrounding TBML schemes and how they affect the local community. Where appropriate, trade fraud and associated crimes should be part of their financial investigations education. The State and Local Anti-Terrorism Training (SLATT) program funded by the U.S. Department of Justice, Bureau of Justice Assistance (BJA) is an excellent starting point. The SLATT program is dedicated to providing specialized multiagency anti-terrorism detection, investigation, and interdiction training and related services at no cost to our nation's law enforcement officers, who face the challenges presented by the terrorist and violent criminal extremist threat – including the detection of opaque underground financial systems sometimes employed by terrorists.[xiii]

With an expanded TTU, there should be more sharing of targeted trade data with local law enforcement. In addition, appropriate U.S. import and export trade data should be made available by the Department of Homeland Security and the Department of Commerce to Treasury's Financial Crimes Enforcement Network (FinCEN). Combined with commercially available data, criminal investigators and analysts should be able to conduct both reactive and pro-active queries into suspicious trade transactions.

We have plenty of laws, rules, and regulations on the books that enable law enforcement to combat financial crimes including TBML. In my opinion, what we need is awareness, consensus, and an emphasis on enforcement.

Other recommendations on combatting TBML and value transfer are included in my new book on trade-based money laundering.

I appreciate the opportunity to appear before you today and I'm happy to answer any questions you may have.

Much of the material in this statement comes from:

John Cassara, *Trade-Based Money Laundering: the Next Frontier in International Money Laundering Enforcement*; Wiley, Hoboken, New Jersey, 2015.

[i] FATF; Trade Based Money Laundering (Paris: FATF, June 23, 2006), p. 1; available online: (http://www.fatf-gafi.org/media/fatf/documents/reports/Trade%20Based%20Money%20Laundering.pdf)
[ii] Ibid
[iii] Analysis given to the author by Dr. John Zdanowicz via June 30, 2015 email.
[iv] "The Economist Highlights the Scourge of Trade Misinvoicing," Global Financial Integrity, May 2, 2014; available online: (http://www.financialtransparency.org/2014/05/02/the-economist-highlights-the-scourge-of-trade-misinvoicing/)
[v] "New Study: Illicit Financial Flows Hit US$1.1 Trillion in 2013," Global Financial Integrity, December 8, 2015; available online: http://www.gfintegrity.org/press-release/new-study-illicit-financial-flows-hit-us1-1-trillion-in-2013/
[vi] Brett Wolf, "The Hide and Hair of Terrorist Finance in Pakistan," *Complinet,* January 17, 2007.
[vii] Dilip Ratha, "Remittances, Funds for the Folks Back Home," International Monetary Fund; available online: (http://www.imf.org/external/pubs/ft/fandd/basics/remitt.htm)
[viii] Raymond W. Baker, Capitalism's Achilles Heel, John Wiley & Sons, Hoboken, New Jersey, p. 134
[ix] Source: John Cassara, "Fighting Terror with Analytics," SAS.com Magazine, (available online http://www.sas.com/news/sascom/terrorist-financing.html)
[x] Dr. John Zdanowicz, *Trade-Based Money Laundering and Terrorist Financing;* available online: https://datapro.fiu.edu/campusedge/files/articles/zdanowiczj3008.pdf
[xi] March 26, 2015, email exchange between the author and Hector X. Colon, he unit chief/director of the TTU
[xii]William Mauldin, "Details of Pacific Trade Pact Fuel Debate," Wall Street Journal, November 5, 2015; available online: http://www.wsj.com/articles/pacific-trade-agreement-terms-herald-public-battle-1446712646

[xiii] The Institute for Intergovernmental Research (IIR) serves as the technical service provider for ongoing training, research, and analysis services to the SLATT Program through the support of grant awards received from the Bureau of Justice Assistance. IIR supports the SLATT Program by providing project coordination activities, training assessment, and meeting coordination. See the IIR/SLATT website for additional information; (https://www.iir.com/WhatWeDo/Criminal_Justice_Training/SLATT/)