# The Future of Digital Money Laundering

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**Banks got networked, and money laundering went digital. This is as close to cause and effect as you can get. In the future, successful money launderers will demonstrate a closer affinity to tax cheats than bank robbers.**

Before something can be laundered well, it must be collected and sorted—a truism for both laundry and money. Today's representative money is nothing more than a guarantee by the issuer that the money may be used as legal tender in its jurisdiction, that is, *if* you can find someone willing to accept it. No other guarantees are expressed or implied. Whatever value money may have is a function of the "full faith and credit" of that issuer. So when you launder it, you can't wander too far away from the full faith and credit well.

In the US, our representative money hasn't been based on anything of intrinsic value since President Richard Nixon took our currency off the Bretton Woods gold standard in 1971 (the so-called "Nixon Shock"). Nixon ushered in the era of fiat money—money based on law or government regulation and not on precious metals or other goods—and floating exchange rates that are still in place today. Although economists might disagree on whether fiat money is the stuff on which sound economic policy should be based, there's no disagreement on whether it can go very bad for the holder. As one data point, Amazon currently sells uncirculated $100 trillion Zimbabwe bank notes for US$9.49, plus shipping and handling. That speaks volumes about global confidence in Zimbabwe's full faith and credit. (Incidentally, David Stockman's and Nomi Prins's recent books offer excellent histories of the post–Bretton Woods experience.[1,2] Both offer remarkably similar explanations, but from different political perspectives.)

One step removed from representative money is modern fractional-reserve banking. FRB is a spinoff of the medieval money-lender tally system. Our global FRB is only possible because of modern computers and networks: everything about it is digital. Modern money laundering (ML) uses this networked, digital financial ecosystem to transform illegally obtained money into legitimate money that isn't under suspicion by law enforcement. *Reverse* money laundering (RML) works much the same way, but in the opposite direction: legitimate money is infused into a system to support criminal activity. RML's notoriety rose after the 9/11 attacks. As former US Department of Justice Deputy Chief for Money Laundering Stefan Casella pointed out, the existing ML statutes were too rear-looking and international to be effective in dealing with RML—they left significant statutory holes through which domestic RML could be used as a means to fund future criminal behavior.[3]

## ML AS AN ART FORM

These days, digital ML's success revolves around access to one particular node: the US financial system. Access to this node could include traditional money exchange via bank accounts, letters of credit, money service

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businesses (Western Union, check cashing services, and the like), correspondent banking, legal trusts, and so forth. Orthogonal to the financial grid are formal and informal remittance systems, charities, Hawala networks, formal value-transfer systems such as the Black Market Peso Exchange, virtual or crypto currencies that use centralized exchanges (such as Bitcoin and Litecoin), consensus-trusted ledger systems that rely on protocols (like Ripple), so-called "Dutch sandwiches" (the use of a deposit in one jurisdiction as collateral in another), and so forth. The entire ML enterprise is akin to a map of trade routes for nuanced global financial relationships.

That's the *how* of ML. The *why* usually has to do with the source of the money. Sales of illegal goods (as in drug and arms trafficking) are common sources, but so are proceeds from extortion, kidnapping, prostitution and human trafficking, fraud, corruption, counterfeiting, crimes of violence, and—the largest single source of global ML—tax fraud. If the producing activity is illegal, the revenue is in the darker part of the shadow economy. If the originating activity is legal, but the revenue isn't reported to tax authorities, it's in a grayer part of the shadow economy.

Due to increased government regulation, ML activity has had to migrate to the "grayer" zones—an area well charted by tax cheats whose tax havens were specifically set up to avoid tracking of their financial transactions. Not surprisingly, a common defense against ML prosecution used to be the "innocent owner" excuse. In the past few decades, because of feckless enforcement of statutes, the larger ML "banksters" now cop pleas with minimal discomfort. For example, in May 2014, Credit Suisse agreed to pay $2.6 billion in penalties for its complicity in tax avoidance

as part of a plea deal in which its executives avoid all criminal prosecutions, its investment-adviser license remains intact, and none of its tax-evading US account holders are divulged to authorities.[4,5]

This is despite the fact that Credit Suisse was found to have used anonymous accounts, sham entities, and offshore trusts and corporations to assist its US clients in tax evasion. Although Attorney General Eric Holder has stated that in principle no bank executive is too powerful to jail, history has proved otherwise.[4] Similarly, in 2012, HSBC was fined $1.9 billion for laundering proceeds from an undisclosed amount of illegal narcotics sales,[6] but its executives received no jail time. Since the 1999 "Holder Memorandum"[7] that outlined the "collateral consequences doctrine," noncriminal settlements like deferred prosecution have become the default for banks that are "too big to jail." This describes a general phenomenon that economists call "competition in laxity." See Figure 1 for an overview of the typical ML cycle and the tools and entities involved.

## COCAINE COWBOYS AND COWGIRLS

The golden age of ML might well have been the 1980s in South Florida, when "cocaine cowboys" pushed carloads of money through the counting rooms of participating banks. The banks skimmed their percentage before depositing the funds in the local branch of the Federal Reserve.

Back then, teller windows were as porous as the Florida coastline, but those days are long gone due to aggressive regulatory enforcement. Today, ML techniques are far more insidious—they include use of a straw man or anonymous accounts in foreign banks located in uncooperative—as far as IRS enforcement—tax havens. Although this has always been an option for

the major criminal organizations, it was considered a backup plan until just recently because it required yet another hop to get into the US financial network. Tougher statutes and more rigorous enforcement have driven ML underground and completely into the digital world, where it's harder to detect and involves no heavy lifting.

The magic of successful ML has always been in the avoidance of tracking. ML is like prestidigitation—think Penn and Teller gone digital (www.youtube.com/watch?v=oXGr76CfoCs). Money launderers usually begin with anonymous bank accounts (numbered, code-named, straw man) and then follow up with "placement" of the dirty money into the financial networks via bearer shares, transfer companies, front or shell companies, charity accounts, proprietaries, correspondence bank accounts, Hawala networks, pass-through accounts, trusts, and so forth. The more successful money launderers introduce as many degrees of separation between the source and ultimate destination of money as possible (this is called "layering" in the trade). Usually at least one end of the money trail lies offshore in an uncooperative tax haven like Liechtenstein, Monaco, Andorra, the Cook Islands, Switzerland, Luxembourg, Panama, and others. (For a recent list, see the 2013 Congressional Research Service report.[8]) Corporate tax evasion includes techniques such as earnings stripping, transfer pricing, cross-crediting, and the like. The use of the tax laws for tax evasion explained in the Congressional report is critical to understanding why tax evasion in general, and ML in particular, is largely unstoppable.

*The Economist* recently broke out tax havens by areas of specialization and client base.[9] Correspondent banking's profit potential is so large that a giant economic incentive circumvents any restrictive regulations
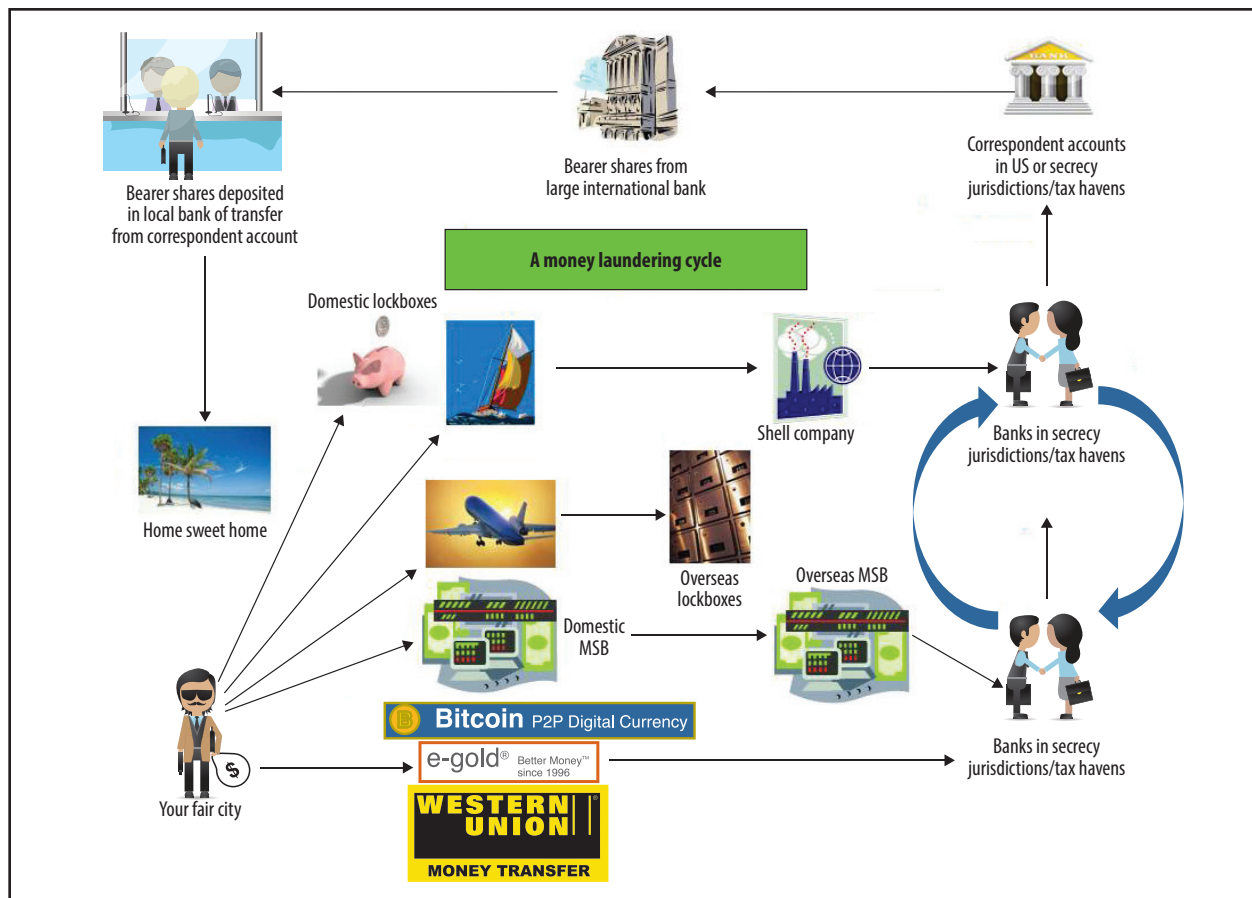
**Figure 1.** A typical money laundering cycle. MSB, money services business.

as long as the government continues its "too large to jail" philosophy with respect to facilitating banks and bankers. Former bank regulator William Black refers to this philosophy as the "three Ds": deregulation, desupervision, and de facto decriminalization.[10]

The facilitating bank is the primary ML crime scene as described in the Credit Suisse and HSBC examples above. The closure of shell banks, offshore banks, and shell corporations in noncooperating tax havens just causes them to relocate or redefine themselves—this is the jurisdiction-shopping, whack-a-mole side of ML.

From the facilitating correspondent bank's perspective, due diligence involves determining sufficient information about a candidate bank's "parentage, respectability, and integrity" to

make the "innocent owner" defense plausible—it doesn't have to be *true* under current prosecutorial standards, just *plausible*. Once again, look where financial incentives lie. Correspondent banking is "found money" as far as the facilitator bank is concerned—the revenues from services and fees for correspondent banking amounted to $590 billion in 2010 according to a recent SWIFT white paper—that's serious money.[11] Now just how much due diligence can we expect from the financial industry when a $590 billion revenue stream is at stake? (Correspondent banking's key ML issues were laid out in testimony before the Senate Committee on Government Affairs in 2001.[12]) Correspondent banking is the suds cycle in a money laundromat.

This is not to deny that in rare

circumstances banks are closed for criminal activity. Castle Bank and Trust in the Bahamas, Nugan Hand Bank in Australia, and the International Bank of Credit and Commerce were all closed following investigations into their involvement in ML, narcotics trafficking, illegal arms deals, and sundry covert CIA operations (see Alfred McCoy's *The Politics of Heroin: CIA Complicity in the Drug Trade*[13]). Such cases are fading into distant memory after the Holder Memorandum's inception. The politically influential financial industry is largely self-sealing when it comes to criminal activity—evidence doesn't leak out.

Correspondent accounts, bearer shares, tax havens, and the like are individually and collectively criminogenic. The Justice Department's "faith-based" oversight is by

design inadequate to the challenge. Therein lay the golden opportunities for future money launderers.

## GO BIG OR GO HOME

So far, we've covered successful ML strategies from the tax fraud perspective. Available evidence suggests that for politically influential big banks caught laundering money, the worst-case scenario is a modest fine. In the HSBC example, the $1.9 billion fine in 2012 for laundering billions in narco-dollars was approximately 10 percent of its annual profit—not much of a disincentive compared with the enormous potential profits. A billion dollars here and there is just the cost of doing business.

Before driving this point home, let me briefly discuss some failed tactics. Examples of digital criminal activity that hasn't panned out to any significant degree include online "deep Web," Tor–hidden services like Silk Road.[14] At its zenith, Silk Road produced a few million dollars in monthly revenue—chump change compared to the scales discussed above. Service owner Dread Pirate Roberts' mistake was in relying on security through obscurity, which didn't keep Silk Road any more secure than proprietary code-secured Internet Explorer. Dread Pirate Roberts did for the illegal online marketplace what Cliven Bundy did for the sovereign citizen movement: in effect, both functioned as law enforcement intelligence honeypots.

Another tactic that just won't stand the test of time in ML is the use of crypto currencies such as Bitcoin, Peercoin, and Litecoin. They simply aren't good vehicles for large-scale ML because crypto currency security is predicated on the algorithmic computational complexity behind the proof-of-work systems. Some of us are old enough to remember that a similar argument was used to defend the 1975 Digital Encryption Standard! As with DES,

crypto currency proponents fail to appreciate that when the stakes are high enough, the attack vectors are rarely limited to frontal assaults on algorithmic bastions.

ML via prepaid products—such as gift cards—will also be in decline. When issued by global banks, open loop or use-anywhere, cash access, online-compatible, prepaid cards are as useful as cash—and a lot better for transnational currency movement because there's no evidence on the card itself. As law enforcement gains increasing statutory authority, the utility of these instruments will decline precipitously, and prepaid products will become relatively useless as serious ML instruments.[15]

I should mention one potential ML vector that has been in the news recently: online gaming.[16] There has been considerable publicity associated with casino magnate Sheldon Adelson's full-court press to create a federal ban of online gaming through his Coalition to Stop Internet Gambling. This resulted from a 2011 Justice Department ruling that states could regulate online gaming under the 1961 Wire Act.[17] Although online gaming does expose the player to fraud through collusion attacks and carries some attendant privacy risks, ML through online gaming is really only practical at the micro level. Convenience gambling is both easier and leaves less evidence behind.

Deep Web merchandizing, crypto currency, prepaid cards, online gaming, and, of course, the old standby—credit card fraud—are the later digital ML entries.[17] However, let's not overlook nondigital legacy tactics that involve converting dirty cash to physical assets like fine art, antiques, precious metals, rare coins and stamps, race horses, and so forth.[18] Though still used, this kind of "integration" harkens back to the days of Al Capone and Willie Sutton. Attempts to convert fractional

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My point is that the current level of regulatory oversight has pretty much eliminated ML's low-hanging fruit and driven it into the higher branches inhabited by tax cheats. Because no other strategy yields the same degree of success, this has to be the direction that the next wave of money launderers will take. Their role models will be bank officers and tax cheats, not bank robbers and smugglers.

## CASE HISTORIES FROM THE US SENATE

My prediction can be—with just a little effort—extrapolated from the 2008 US Senate Staff Report, "Tax Haven Banks and US Tax Compliance."[19] This report is an important view into the future because it identifies the tax evasion types most difficult to identify and prosecute—see the "Observations from the Report" sidebar for key ML tactics. In the words of Senator Carl Levin, "too often US banks have failed to conduct the initial and ongoing due diligence … of foreign banks using their services."

According to an Internal Revenue Service April 2013 report, the 2006 tax gap (the difference between taxes owed and those actually

## OBSERVATIONS FROM THE TAX GAP REPORT

- Correspondent accounts are absolutely essential for moving capital around the world. That's the primary vehicle that businesses have for money transfers and account settlement, especially when large sums are involved. Politicians who wish to remain in office will suggest regulation at their political peril.

- The remittance-transmitter industry is toast when it comes to future ML. Money service businesses are easy to regulate because they aren't an integral part of the financial industry. Using technology to shut off cash remittances comes with little attendant political cost, as the principals tend to have little lobbying influence with Congress. From a political point of view, it's easier for the government to stop all money transfers over 50 cents than it is to prosecute a banker or billionaire tax cheat with multimillion-dollar accounts in Liechtenstein.

- Government regulators are fixated on crimes outside the US and external to the US financial industry—specifically, the ML associated with narco-trafficking, terrorism, and the like. This produces no political blowback, as no one will pity a foreign drug lord or terrorist organization. A perfect example of this can be found in Operation Casablanca, in which the US Department of Justice indicted 3 Mexican banks and 26 Mexican bankers for laundering money from illicit drug profits. Not one US bank or banker was indicted—the investigation stopped at the border. ML involves a cycle that usually passes through the US financial network. The cycle is incomplete without an anchor in the US!

- The US Department of Treasury admits that it's usually impossible to determine beneficial ownership of a carefully structured trust, company, or partnership organized under foreign law. "If a US person can arrange to receive investment income through means that permit the US person to appear to be a foreign person, the US investor may be able to evade US income tax entirely."[1]

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com/2010/01/22/us/politics/22scotus.html?Pagewanted=all), increasingly empowered. Future money launderers have no choice but to stay close to their well.

Major international banks like HSBC, JPMorgan Chase, and Bank of America process trillions of dollars of transfers daily, almost all of which are automated and require no human oversight. It's important to understand that these transfers don't require credit, so due diligence won't be conducted for the sake of risk aversion, but simply for the sake of compliance. But banks are incentivized to engage in anti-ML compliance only to the extent that they avoid the modest fines. Their greatest potential risks—to criminal prosecution and forfeiture of US capital markets access—isn't a real threat as long as governments continue to offer the banking industry perverse incentives.

During the Warren Harding administration nearly a century ago, Albert B. Fall, a corrupt secretary of the Interior, was found guilty of accepting bribes in exchange for favorable lease arrangements of the Teapot Dome Oil Field to, among others, Harry Sinclair of Sinclair Oil Co. Although Fall was convicted, the well-lawyered-up Harry Sinclair was found not guilty of fraud and bribery. This prompted Senator George Norris from Nebraska to remark, "He has too much money to be convicted. We ought to pass a law now to the effect that no man worth a hundred million dollars should ever be tried for any crime." Norris's quote appears in Ferdinand Lundberg's 1937 classic, *America's 60 Families*.[21] Lundberg went on to say that "such legislation would serve to formalize de jure an existing condition, and would at least make consistency between theory and practice." Norris and Lundberg

paid) was $450 billion. To put this in perspective, in 2012, the White House estimated that the US's total annual expenditure on illegal drugs from 2000 to 2006 was $103 billion.[20] That is, if the government took over the illegal drug business, its total revenue would be less than a quarter of the amount lost to tax fraud. Therefore, it's reasonable for bankers to assume that if all proceeds from narco-trafficking and tax fraud are laundered, the total illicit revenue to the banking industry is at least $550 billion per year, which translates into billions of dollars in vig for the handlers. So it's pretty clear that future success in ML will be proportional to ML's ability to emulate tax fraud—it's rapidly becoming the best game in town. This tax gap is as permanent a benefit to the political donor class as tax shelters, tax credits, property tax abatements, private letter rulings, accelerated depreciation, and deferred income. Its beneficiaries are rich, powerful, and, after *Citizens United v. Federal Election Commission* (www.nytimes.

seem to have anticipated the Holder Memorandum. I might add that since most politicians seem to recognize no fiduciary duty to anyone but themselves, the status quo may be counted on to provide the requisite insulation from the law for the foreseeable future. ■

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