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The general who is skilled in defense hides in the most secret recesses of the earth.

– Sun Tzu, Chinese military philosopher (circa 500BC)

On February 5th 2020, the District Attorney for the District of Columbia in the United States filed an indictment against 28 North Koreans and five Chinese nationals, accusing them of operating covert branches in various jurisdictions for Foreign Trade Bank (FTB), a North Korean bank subject to US economic sanctions[1].

Instead of opening official representative offices or full bank branches in foreign jurisdictions, FTB hid covert branches in several countries to handle correspondent banking transactions that would otherwise have been banned due to the implementation of economic sanctions.

Having laundered over USD2.5 billion on behalf of FTB[2], the covert branches operated discretely to extend FTB's Pyongyang head office capabilities into USD payments within global correspondent banking networks. For financial institutions concerned about defending their correspondent/respondent banking networks from money laundering and proliferation financing activity, this sophisticated form of sanctions evasion elevates certain risks within international payments and trade finance.

In March 2013, the US government imposed economic sanctions on FTB for its involvement in proliferation financing for weapons of mass destruction (WMD) under development by North Korea, the owner of FTB[3]. Of all the WMD categories – chemical, biological, radiological and nuclear – it is North Korea's nuclear weapons program that causes the most concern among competent governments around the world.

The development of a nuclear weapons program requires a number of sophisticated pieces of equipment to perform certain tasks, such as refine uranium, maintain an operational payload and detonate a nuclear device. For rogue regimes such as North Korea, the lack of domestic production of certain key components necessitates importing equipment from abroad. International trade therefore becomes essential in building a nuclear weapons program.

FOR ROGUE REGIMES SUCH AS NORTH KOREA, THE LACK OF DOMESTIC PRODUCTION OF CERTAIN KEY COMPONENTS NECESSITATES IMPORTING EQUIPMENT FROM ABROAD. INTERNATIONAL TRADE THEREFORE BECOMES ESSENTIAL IN BUILDING A NUCLEAR WEAPONS PROGRAM.

Abdul Qadeer Khan, the architect of the Pakistani nuclear weapons program, operated a global network of suppliers and trading companies to support the acquisition and shipment of weapons components into and out of Pakistan[4]. Khan built a vast personal fortune importing and exporting weapons components and technical specifications[5]. Judging from the indictment, certain named North Koreans and others had hopes of creating their own fortunes through WMD proliferation financing.

As a state-owned bank, FTB would be encouraged by the regime to construct and maintain correspondent banking capabilities to support the necessary trade of WMD components. With FTB sanctioned by the US government, its options for correspondent banks would be extremely limited, if available at all.

ManchesterCF Financial Intelligence

ManchesterCF
Suite 501
125-720 King Street West
Toronto, Ontario
Canada M5V 3S5
+1.416.388.6051
manchestercf.com
info@manchestercf.com

If FTB was able to find a foreign financial institution to operate on its behalf, it would be "nesting" its banking activity within the foreign bank. Such institutional nesting is a common technique for sanctioned banks to evade the limitations imposed upon them by economic sanctions. Many financial institutions have been caught offering nesting services to sanctioned banks and have paid fines and settlements amounting to hundreds of millions, and in some cases billions, of dollars.

FTB ESTABLISHED CORPORATIONS IN CHINA (ZHUHAI, SHENYANG AND BEIJING), LIBYA, RUSSIA (VLADIVOSTOK AND KHABAROVSK), THAILAND, KUWAIT AND AUSTRIA. THE FTB COMPANIES WOULD OPEN UP BANK ACCOUNTS IN THEIR COUNTRY OF RESIDENCE AND AWAIT INSTRUCTIONS FROM FTB.

Yet FTB did not choose the institutional nesting option to effect USD payments. According to the indictment, FTB established corporations in China (Zhuhai, Shenyang and Beijing), Libya, Russia (Vladivostok and Khabarovsk), Thailand, Kuwait and Austria. The FTB companies would open up bank accounts in their country of residence and await instructions from FTB.

Using coded messages, FTB's head office would instruct an FTB company to issue payments in USD to a foreign exporter for goods to be sent into North Korea, or have an FTB company receive payments on behalf of the North Korean government for an export shipment. The scheme is successful if any observer to such a transaction is unable to connect the corporation to FTB via ownership documentation or company directors associated with FTB. Going undetected, the covert branch is then capable of acting as a rudimentary bank branch for inbound and outbound payments for FTB head office.

The indictment suggests that US correspondent banks for USD payments would raise questions about the parties involved in these payments. If the domestic bank for an FTB covert branch raises uncomfortable questions or connects the dots to FTB in Pyongyang, the corporate entity can be shut down quickly. A new FTB covert branch could be opened by acquiring an existing corporate entity or incorporating a new vehicle. From the standpoint of the US correspondent bank, it is an endless game of chasing after corporate shells that are not what they appear to be.

IF THE DOMESTIC BANK FOR AN FTB COVERT BRANCH RAISES UNCOMFORTABLE QUESTIONS OR CONNECTS THE DOTS TO FTB IN PYONGYANG, THE CORPORATE ENTITY CAN BE SHUT DOWN QUICKLY. A NEW FTB COVERT BRANCH COULD BE OPENED BY ACQUIRING AN EXISTING CORPORATE ENTITY OR INCORPORATING A NEW VEHICLE.

Aside from basic payments, the North Korean government would act as a confirming agent for some shipments. In 2015, FTB head office guaranteed that funds for a shipment of aluminium to a North Korean purchaser would be paid directly to a Thai front company if the purchaser was unable to pay within a six-month window. FTB head office essentially offered a letter of credit confirmation to an international trade transaction, stepping in with their own reputation in case a credit failure harmed the transaction. This is an extraordinary measure to manage risks within international trade, yet for a sanctioned North Korean financial institution, it may have been a matter of necessity.

The corporations created by FTB staff or their agents to act on behalf of FTB outside of North Korea had to open corporate banking relationships with banks in their operating jurisdictions. According to the indictment, some of these banks would have been aware that the corporate entity was owned by FTB, however it is unclear if all financial institutions working with FTB companies were aware of the linkages to FTB and the North Korean government.

According to the indictment, banks in Singapore, Malaysia, Thailand, China, Russia, Austria and the US dealt with FTB companies acting on behalf of FTB head office. These banks may face legal or regulatory consequences for failures in their economic sanctions and anti-money laundering regimes if they were unaware of the FTB corporate entity's true ownership structure.

For those that wilfully chose to engage in a commercial relationship with a sanctioned North Korean bank, the consequences could become severe. Under extreme circumstances,

ManchesterCF
Suite 501
125-720 King Street West
Toronto, Ontario
Canada M5V 3S5
+1.416.388.6051
manchestercf.com
info@manchestercf.com

they may find themselves designated as financial institutions of “primary money laundering concern”[6] and subsequently barred from engaging in USD transactions, a death sentence for any financial institution.

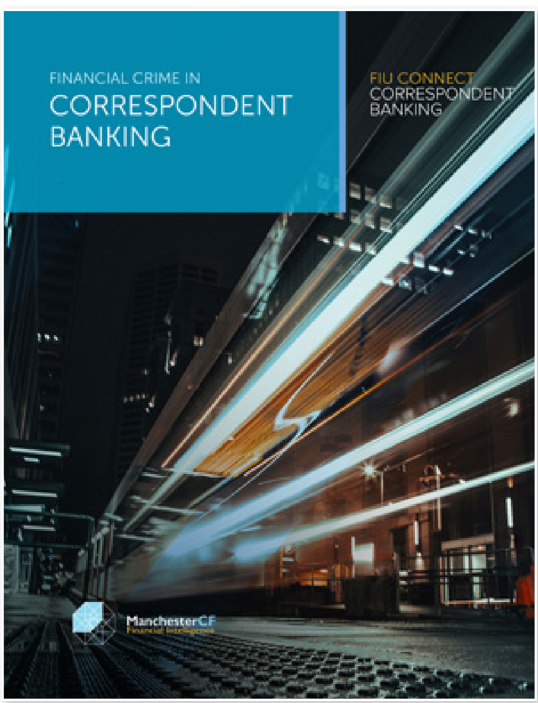
Perhaps one of the most bizarre facts outlined in the indictment lay within the communication between FTB head office and its covert branches. Reference numbers for specific transactions cited in intercepted communication contained specific text associated with telephone numbers of involved parties, bank account numbers and Society for Worldwide Interbank Financial Telecommunication (SWIFT) bank identification codes (BIC) for sanctioned banks. This is not sophisticated tradecraft for any foreign intelligence operation.

FOR THOSE THAT WILFULLY CHOSE TO ENGAGE IN A COMMERCIAL RELATIONSHIP WITH A SANCTIONED NORTH KOREAN BANK, THE CONSEQUENCES COULD BECOME SEVERE. UNDER EXTREME CIRCUMSTANCES, THEY MAY FIND THEMSELVES DESIGNATED AS FINANCIAL INSTITUTIONS OF “PRIMARY MONEY LAUNDERING CONCERN”.

Financial institutions should perhaps consider checking transaction memo fields within corporate and institutional payments for the BIC codes of sanctioned banks. The same may be true for MTX99 free text messages sent between financial institutions, as lazy sanctions evaders may be obtuse enough to insert these types of reference numbers within their SWIFT messages.

The indictment states that US correspondent banks raised due diligence questions through respondent banks about the FTB covert branches. If enquiries from the US correspondent banks about their respondent’s customer did raise the hackles of an AML compliance officer, perhaps a suspicious activity report (SAR) made its way into the US financial intelligence unit, the Financial Crimes Enforcement Network (FinCEN).

Perhaps a small collection of these SARs were enough to spur on an investigation by intelligence agencies into the overseas activities of FTB, leading to an indictment that dismantles a proliferation financing network. If that is indeed the case, then despite its many challenges, perhaps the AML compliance/financial intelligence system does indeed work. In an increasingly chaotic world, this would be good news for all of us.



[1] https://int.nyt.com/data/documenthelper/6971-north-korea-indictment/422a99ddac0c39459226/optimized/full.pdf#page=1

[2] https://www.nytimes.com/2020/05/28/us/politics/north-korea-money-laundering-nuclear-weapons.html

[3] https://www.treasury.gov/press-center/press-releases/Pages/jl1876.aspx

[4] https://www.foreignaffairs.com/articles/north-korea/2018-01-31/long-shadow-aq-khan

[5] https://www.twelvebooks.com/titles/douglas-frantz/the-man-from-pakistan/9780446199582/

[6] https://www.fincen.gov/resources/statutes-regulations/usa-patriot-act

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Suite 501
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Canada M5V 3S5
+1.416.388.6051
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