Can economic sanctions lead to fraud? Nations might turn to virtual currencies if slapped with restrictions

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Published in:
Fraud Magazine

Fraud Magazine
May/June 2019
Article: virtual currencies
Draft 2: Carozza, Primeaux

Can economic sanctions lead to fraud?

Nations might turn to virtual currencies if slapped with restrictions

Countries routinely use sanctions on nations to deter and penalize bad behavior. But what if economic restrictions cause criminals to see the anonymity of alternative currencies? We possibly could see increases in fraud, money laundering and terrorism financing. Or not. The jury's still out. Here's what fraud examiners and law enforcement can do as nations move to their own parallel virtual and traditional monetary systems.

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The perpetrator of an $80 million Ponzi scheme needed to launder his dirty money, so he funneled the cash through a Denver online virtual currency exchange backed by established American venture-capital firms, according to a recent Wall Street Journal investigation. (See "How Dirty Money Disappears Into the Black Hole of Cryptocurrency," by Justin Scheck and Shane Shifflett, The Wall Street Journal, Sept. 28, 2018, tinyurl.com/ycpo6j8d.)

Governments and law enforcement agencies have long been concerned that virtual currencies can help facilitate money laundering, fraud and terror financing. They've believed that virtual currencies' anonymity and the absence of middlemen make them attractive instruments to finance crimes with ease. But is this concern justified? The debate continues. One school of thought views virtual currencies as an effective terror-funding tool, for example. But another perceives them as ineffective

because terrorists need specialized training to use them, and they're limited by virtual currencies' negotiability and volatile risk.

We need to understand this debate on terror financing via fraud and money laundering in light of the increase in U.S., EU and U.K sanctions on several countries in response to bad behavior, including human rights violations, support of terrorism and inciting of violence and unrest. Nations often try to circumvent sanctions, limit access to their currencies from outsiders and avoid working with well-established financial institutions.

A theory goes that an increase in sanctioned countries — such as Iran, Russia and Turkey — could instigate an anti-dollar war, and they'd abandon the U.S. dollar as the preferred currency in global trade. Those nations could then adopt another trading exchange, such as virtual currencies or China's planned currency, "renminbi." (See "China's RMB Internationalization Strategy: Its Rationales, State of Play, Prospects and Implications," by Hyo-Sung Park, Harvard Kennedy School, Mossavar-Rahmani Center for Business and Government, tinyurl.com/y6lt9bj2.)

Similarly, terror organizations, organized crime and fraudsters could resort to alternative trading currencies and to financial institutions with less exposure to the U.S. and the EU and hence become subject to less regulations.

Let's dive into this topic and these questions in more detail.

What are virtual currencies?

Virtual currencies, in simplest terms, are representations of value exclusively in a digital form. They can be used as currencies by meeting the criteria of store of value, unit of account and a medium of exchange.

One popular (perhaps the best known) example of a virtual currency is bitcoin, which users promote as a decentralized form of cryptocurrency. In other words, it's a virtual currency without a central intermediary administering or monitoring it. The prefix *crypto* accurately suggests the use of cryptography in its operations. (See "A Light Touch of Regulations for Virtual Currencies," chapter 16 in "Handbook of Digital Currency," by Lam Pak Nian and David Lee Kuo Chuen, 2015, Academic Press, tinyurl.com/y63jxqzp.) A few other examples of cryptocurrencies include Zcash, Ethereum and Bitcoin Cash.

The definition, scope and regulation of what constitutes virtual currencies and their admissibility varies across jurisdictions. We see a wide spectrum of regulations with little global uniformity. For example, China's virtual currency laws are restrictive, but these currencies are unregulated in Australia. Some countries, such as the Republic of Marshall Islands, have made a move toward adopting a digital currency as its second legal tender. (See "Marshall Islands warned against adopting digital currency," by Chris Baraniuk, BBC News, Sept. 11, 2018, tinyurl.com/y8ybleg4.)

Virtual currency proponents say they're efficient and have low transaction costs that facilitate micropayments, which could enable businesses — such as music download services — to make more profits.

However, the absence of central intermediaries in virtual currencies can raise all kinds of problems. It might be impossible to hold parties accountable for counter-party risks because transactions take place on distributed networks. That is, as transactions take place on the blockchain, the parties are not bounded by any central intermediary to fulfill any contractual obligations. Also, consumers and investors are at risk of losses from large price fluctuations and hacking of virtual currency exchanges.

However, criminals might think that virtual currencies are a better medium of exchange for anonymous trading of prohibited items on the dark web because it hinders investigations. And because of limited regulatory oversight it's relatively easy for money launderers and terrorists to convert fiat money into virtual currencies, transfer them to a desired destination and convert them back into fiat currency. Therefore, virtual currency enables them to easily execute the stages of money laundering: placement, layering and integration.

Virtual currencies as a facilitator of terror financing

We've yet to see a consensus on the debate as to whether virtual currencies help facilitate money laundering, fraud and terror financing. One research study analyzed virtual currencies like E-Gold and Liberty Reserve and found anonymity and intractability of transactions along with a lack of regulatory oversight to be key drivers for money laundering. (See "Mitigating virtual money laundering: An analysis of virtual worlds and virtual currencies," Leanne Stuhlmiller, Utica College, 2013, tinyurl.com/y6ysc3zt.)

In contrast, an opposing view holds that virtual currencies' anonymity is unlikely to encourage their wide usage for fraud, money laundering and terror financing because, as we've written, of their negotiability limitations and risk, and criminals need specialized training to use them. In essence, because universal acceptability of cryptocurrencies is still absent, criminals eventually will need to revert back to fiat currency. Also, their unequal distribution and volatility might make them unattractive for use among potential illicit actors. (See "Cryptocurrencies: an unconventional challenge to the AML/CFT regulators?" by Victor Dostove and Pavel Shust, *Journal of Financial Crime*, 2014, volume 21, issue 3, tinyurl.com/y37sttu3.)

The U.S. Congress Subcommittee on Terrorism and Illicit Finance shares this opposing view. In September 2018, the subcommittee stated that virtual currencies still aren't an appropriate medium of exchange for terror groups because they need to purchase goods with cash in geographical areas with a lack of technological infrastructure. Also, the subcommittee concluded that multiple terror organizations have failed in their attempts to generate funds through virtual currencies, and thus fiat money still remains the first choice of funding among terror groups. (See "Terrorists Failing to Raise Funds via Crypto – U.S. Congressional Hearing," by Solomon Sunny, Smarterum, Sept. 10, 2018, tinyurl.com/yxdc42ms.)

Terrorists and fraudsters might not be using virtual currencies effectively now, but the currencies' daily volatility could change circumstances in a moment.

What are sanctions?

Sanctions are limitations that one country or group of countries imposes on another country, and sometimes, on specific citizens of that country. The reasons for imposing sanctions can vary from retaliating for perceived unfair trade practices to opposing human rights violations.

Sanctions generally fall into two broad classifications: asset freezes/seizures and trade sanctions. Asset freezes are designed to restrict the movement and sale of assets from a country or an individual in that country. Trade sanctions can involve: 1) imposing import or export duties on goods 2) quotas limiting the amount of goods that can be traded between countries and 3) embargoes that ban supply of various goods and services from one country to another.

At times, countries might impose technology, information and material sanctions to deter development of weapons, for example, in Iran in 2012. Sanctions are

considered to have a greater impact when the objectives are realistic such as expressing discontent over governments' policies, as opposed to cases where the goal is changing political regimes through the use of military operations. (See "What are sanctions, and do they work?" Huffpost, Sept. 8, 2015, tinyurl.com/yxvup94u.)

Violation of a sanction is generally a criminal offense in the jurisdiction in which they're applicable. Therefore, many countries are strengthening their law enforcement agencies with expertise and training to identify sanction violations with a view to prosecute violators.

The U.S. Treasury Department's Office of Foreign Assets Control (OFAC), among other agencies, executes sanctions and identifies violators. The OFAC also maintains a list of Specially Designated Nationals (SDNs) whom they restrict access to U.S.-dominated global financial systems. (See "Facing the Challenge of Sanctions," by Simon Dilloway, *ACAMS TODAY*, May 27, 2016, tinyurl.com/yylrxc3y.)

Will sanctions pave way for anti-dollar war and a break for fraudsters?

Nations, including the U.S., impose sanctions on other countries because of human rights violations, nuclear trade, crime, terrorism, intellectual property theft, unfair trade practices and corruption. The imposition of sanctions or even the threat of sanctions might hurt an economy.

The U.S. has engaged in so-called economic warfare against Russia, Venezuela, Iran, Cuba, Sudan, Myanmar, Zimbabwe, North Korea and the Democratic Republic of Congo and has imposed punitive economic measures on China, Turkey and Pakistan. Together, these countries constitute a combined gross domestic product of more than $15 trillion.

Any transactions conducted in U.S. dollars or through a U.S. financial institution makes parties of that transaction subject to U.S. regulations. Trading partners have to choose between trading with the sanctioned economy or with the U.S.

Nations that impose sanctions run the risk of bringing together countries that attempt to initiate separate, parallel financial systems. According to some reports, the Iran, Russia and Turkey governments are saying they're avoiding U.S. dollars in their trade transactions. (See "Iran, Russia, Turkey Agree to Ditch Dollar in Transactions," Syndigate.com, MSN Middle East, Sept. 9, 2018, tinyurl.com/y5yg3k2z.)

And, according to Gal Luft, co-director of the Institute for the Analysis of Global Security, Russia and China have "developed their own versions of the Society for Worldwide Interbank Financial Telecommunication (SWIFT), the global network that allows cross-border financial transactions among thousands of banks." (See "The anti-dollar awakening could be ruder and sooner than most economists predict," by Luft, CNBC, Aug. 27, 2018, tinyurl.com/ydx76nj7.)

However, the bad-actor countries still have to deal with value fluctuations and instability of non-U.S. currencies, such as Turkey's lira and Russia's ruble. And countries, such as Turkey, Russia and Iran, lack a major share in global trade of goods and services. The three have a combined contribution of approximately 4 percent of global trade of goods and about 3 percent in services, excluding trading with EU countries. So, it will take a lot more than these countries' efforts to shift the global paradigm of trading in U.S. dollars. (See "Anti-dollar mavericks can't win just yet," by Leonid Bershidsky, Bloomberg, The Japan Times, Aug. 21, 2018, tinyurl.com/yxnjdxfr.) This clearly indicates the need of a partner, and that's where the gradual rise in growth of China's renminbi comes into the picture.

According to Bershidsky, the renminbi currently stands as the second-most popular currency in the world for trade finance with an estimated global market share of 25 percent in 2015. Bershidsky writes that China "faces an uphill battle in winning global share for its currency." In June 2018, according to the SWIFT payment facilitation service, the renminbi's share of global payments reached just 1.81 percent compared with 39.35 percent for the dollar.

Regardless, the rise of the Chinese share in world exports might act as an impetus for a renminbi-dominant trading system. Also, the geopolitical situation might raise the possibility of Iran, Turkey and Russia adopting renminbi in their trading transactions and build the foundation for a shift toward renminbi in global trade. (See "Banking, Trade, and the Making of a Dominant Currency," by Gita Gopinath and Jeremy C. Stein, Harvard and the National Bureau of Economic Research, March 28, 2018, tinyurl.com/y64bwqsm.)

Luft writes in the CNBC article (tinyurl.com/ydx76nj7) that the September 2018 "10th BRICS Summit" was a "call to arms against the dollar hegemony." (BRICS is Brazil, Russia, India, China and South Africa.) The summit participants invited countries like Turkey, Jamaica, Indonesia, Argentina and Egypt to join a "BRICS Plus" initiative aimed at creating a de-dollarized economy.

The initiative explored opportunities to replace the U.S. dollar with digital currencies in trade transactions. The Russian central bank indicated it wanted to launch the "cryptoruble," a national cryptocurrency. Russia has assisted Venezuela in launching its "petro," supported by the underlying asset of its vast oil reserves. The BRICS nations are considering the launch of BRICS-backed cryptocurrency.

Implications for fraud examiners, law enforcement agencies and regulators

Geopolitical circumstances surrounding virtual currencies have several implications.

- With the shift toward alternate currencies in global trade, countries could move toward poorly regulated non-U.S. financial institutions and systems. Undetected suspicious transactions could facilitate an increase in fraud, money laundering and terror financing. Therefore, nations must encourage quality regulations and safeguards in new systems and require that financial institutions and businesses are in compliance.
- Presently, the limitations of virtual currencies — their lack of universal acceptability, negotiability and backing as legal tender — have prevented their use on a large scale. However, some countries might soon overcome these limitations because of their desire to move away from using U.S. dollars for trade. Law enforcement agencies must fast track regulatory and technology development to monitor these anonymous virtual currencies that can facilitate illicit activities.
- The growth in use of virtual currencies might increase the risk of hacking and theft. Therefore, fraud examiners and investigators need to collaborate with digital experts to combat these crimes and develop security measures to provide assurance to investors and consumers. Regulators need to adjust their guidelines to apply to virtual currencies.

Economic sanctions leading to fraud?

The growth in global economies matched with accelerating usage of sanctions as weapons of economic advantage could compel several nations to adopt alternate currencies to the U.S. dollar for trade. This is a future threat, but governments and

regulatory agencies must get the jump now on fraudsters, money launderers and terrorists who could take advantage of these economic possibilities.

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