



Center for a  
New American  
Security

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## Testimony before the House Financial Services Committee Subcommittee on Monetary Policy and Trade

### A Legislative Proposal to Impede North Korea's Access to Finance

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Chairman Barr, Ranking Member Moore, distinguished members of the committee, thank you for the opportunity to testify before you today on U.S. policy options to pressure North Korea through constraints on its access to finance.

North Korea's alarming and dangerous recent expansion of provocations, including more ballistic missile launches and a sixth, powerful nuclear test, highlight the need for much stronger pressure on the regime. This pressure may serve to curb North Korea's threatening activity and facilitate a diplomatic process to advance denuclearization. Financial sanctions should be a core part of such a pressure strategy, along with force posture and projection, and other coercive tools of statecraft, and complemented by serious diplomatic engagement. The United States is placed to lead this effort and must closely coordinate with international partners even as it urges them to do more with secondary sanctions and other gestures.

#### The Sanctions Framework for North Korea, Compliance, and Circumvention

The United States has in place a framework of sanctions to apply financial pressure on North Korea to limit its proliferation activities and the broader revenue streams available to regime leaders. These complement and expand on sanctions put in place by the United Nations Security Council, which instruct member states to cease dealings with North Korean proliferation entities and stop engaging in proscribed economic activities that enrich the regime.

I applaud the recent work of Congress this past summer to impose new sanctions authorities to tighten the financial pressure framework on North Korea, along with new sanctions from the United Nations. Collectively, these new authorities expanded pressure on North Korea with restrictions on economic sectors including energy, metals and mining, transportation, financial services, and seafood, as well as limitations on North Koreans working abroad.

However, as your legislative discussion draft, the focus of today's hearing, aptly points out, circumvention of sanctions and non-enforcement is a major problem and a key reason for North Korea's continued proliferation activities. Tough sanctions authorities cannot, of themselves, create

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meaningful pressure on North Korea to change its policies. Rather, their enforcement, particularly by North Korea's key financial partners, will determine the measures' strength, which may contribute to an effective pressure strategy to facilitate North Korean policy change. In practical terms, effective sanctions enforcement comes down to China, which is responsible for over 90% of North Korea's trade, adopting a strict enforcement posture.<sup>1</sup>

## Application of Secondary Sanctions on North Korea

The regime of current international sanctions may actually be adequate to constrain the ability of North Korea to procure proliferation materials, and to influence its cost/benefit calculation on instigating international threats, if fully enforced. Unfortunately, it is not. Also, these outcomes are not the only goals of most U.S. leaders who now aim to use pressure to change the cost/benefit calculation of China to coerce North Korea into halting its provocations and proliferation.

The United States, at present, does have sweeping, powerful authorities to impose sanctions and conduct law enforcement activities to identify and impede North Korea's international agents and affiliates propping up the regime's proliferation activities and its economic activity. The U.S. administration can go after major international companies, banks, and officials and has announced some important, recent actions to highlight and impede North Korea's international facilitation networks. There is much more that the administration can, and no doubt will, do to continue this work. The primary priority in congressional oversight of U.S. sanctions on North Korea should be to urge and support aggressive implementation of existing sanctions authorities, which will do a great deal to deepen the financial pressure on North Korea and its enablers.

Nevertheless, many legislators and other observers frustrated with non-enforcement and evasion of sanctions, and anxious that sanctions, when they are enforced, are not working rapidly enough, are gravely concerned that time is running out. For some, this translates into the belief that the current U.S. sanctions framework is inadequate, and that the United States should make secondary sanctions "shock treatment" mandatory to force other countries to comply with U.N. sanctions on North Korea. I believe it is time to contemplate where mandatory secondary sanctions would be appropriate to accelerate or deepen the pain of sanctions targeting North Korea. I support the efforts of this committee to consider how such measures should be deployed to send a very clear message to North Korea and those who prop up its regime.

We must not forget, however, that secondary sanctions require great delicacy in their application. Often, just the threat of use or a few carefully-chosen example cases can have the desired deterrent effect to motivate compliance among the global financial community. They may be counterproductive if application of secondary sanctions is so aggressive or politically incendiary so as to make U.S. partners utterly defiant, uncooperative, and move rapidly to create officially-backed evasion schemes and impose retaliatory sanctions and economic punishment on U.S. firms operating abroad. Secondary sanctions can also backfire if their implementation does not allow the targets of these measures to change their policies and effectively comply with sanctions in a manner that is politically acceptable to their domestic constituency. China, for example, is highly unlikely to sever

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<sup>1</sup> Eleanor Albert, "The China-North Korea Relationship," Backgrounder (Council on Foreign Relations, July 5, 2017), <https://www.cfr.org/backgrounder/china-north-korea-relationship>.

its economic activity with North Korea if the only way to do it appears to its population and the global community to be capitulation to U.S. sanctions.

Another risk of secondary sanctions is that their application could have significant unintended consequences for U.S. businesses and individuals, particularly those within China, for rapidly expanding bilateral trade with China, or for the U.S. economy more broadly. If the United States imposes sanctions on major Chinese banks, for example, there could be significant implications for currency devaluation in China, and spillover currency valuation effects elsewhere, making U.S. goods and services less competitive for export. Sanctions on Chinese banks could also negatively impact the U.S. correspondent institutions of sanctioned Chinese banks, or bilateral and international trade, to the detriment of the economic interests of the United States and allies. The largest Chinese banks are the largest global banks, and the United States must move carefully to address any North Korean financing moving through these institutions.<sup>2</sup> We must bear in mind that the highly interconnected nature of our global economy and supply chains means that a disruption or crisis in China will inevitably affect the United States.

Targeted secondary sanctions on the largest Chinese banks could ultimately be the right answer to create pressure on North Korea, but other law enforcement actions or regulatory penalties could be more appropriate to send a strong signal and manage the consequences for the U.S. economy. Ultimately, avoiding pitfalls in the use of secondary sanctions is primarily the responsibility of the U.S. administration, the body that implements and enforces sanctions. Congress must give the administration adequate flexibility, even within a framework of broad mandatory sanctions, to be able to impose aggressive sanctions to pressure North Korea but also manage the consequences and pursue an effective diplomatic and alliance strategy with international partners.

## **A Rigorous, Risk-Based Approach to Countering Proliferation Finance**

In the realm of financial statecraft to apply pressure on North Korea, sanctions are only one set of instruments available to the United States. An overwhelming focus on sanctions as the only or the primary instrument of financial pressure elides the significance of another powerful framework to limit North Korea's proliferation activities. This other framework is a rigorous, risk-based approach by global financial institutions to identify and curtail proliferation finance within their institutions.

Currently, only large U.S. banks, and some major European and Asian financial institutions, holistically pursue proliferation finance, leaving all other global banks significantly vulnerable to abuse by North Korean, or other, proliferators. For these other global banks, weak supervisory frameworks and expectations, lack of knowledge and resources, and insufficient prioritization of the threat means that they often take a mechanical approach to proliferation finance in the form of checking customers or transactions against entities sanctioned by the U.N. or national governments (sometimes, but not always, including the United States). This presents obvious, and documented, opportunities for proliferators to use front companies or proxies to get around limited compliance controls outside of major financial institutions. Very often, banks in high-risk jurisdictions are not asking the right questions to discern when money laundering, cash transactions, or other suspect

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<sup>2</sup> "The World's Largest Banks," *S&P Global Market Intelligence*, <http://pages.marketintelligence.spglobal.com/Global-Bank-Rankings-Request.html>.

activity may be disguising proliferation finance. Information from U.N. reports,<sup>3</sup> investigative journalists,<sup>4</sup> law enforcement cases,<sup>5</sup> and independent experts<sup>6</sup> illustrates how financial institutions offer services to North Korean proliferators and their money laundering fronts, often unwittingly, without rigorous investigation into proliferation finance ties.

The global standard setting body for countering illicit finance, the Financial Action Task Force (FATF), endorses an approach toward proliferation finance along the lines of checking customers against sanctions lists, instead of a broader risk-based evaluation of suspect proliferation conduct or proliferation typologies.<sup>7</sup> FATF is now in the process of updating guidance on proliferation finance. However, it has many more opportunities to provide strong leadership to activate the global banking community to identify and counter proliferation finance in a manner that is commensurate with the current proliferation risk and that is in line with the standards currently applied to other forms of serious illicit activity, such as terrorist financing.

There must be much stronger leadership from best-in-class financial sector leaders as well as from national leaders on the subject of proliferation finance to clarify that global banks must take a more holistic, risk-based approach to screening and investigating for proliferation finance, and there must be strong public-private information exchange around known proliferation entities and typologies. Without such leadership, and indeed without the creation of tough expectations and requirements for global financial institutions, most international banks and their regulators will not change the alarmingly inadequate status quo on countering proliferation finance. They may become better list-checkers if there are more primary and secondary sanctions, but that will not change the culture of compliance enough to truly mitigate the proliferation finance threat. Moreover, without strong signaling for change from FATF, the mandate of multilateral development institutions and multilateral financial service sector technical bodies will not include the provision of technical assistance around a rigorous, risk-based approach to proliferation finance.

Working to change the compliance practices of global banks around proliferation finance concerns will not immediately halt the North Korean threat. It can, however, have a profound, ultimate impact, and is an appropriate and effective complement to additional sanctions on the North Korean regime. Both of these forms of financial statecraft are needed as part of a broad strategy to apply pressure on North Korea and check its ability to engage in proliferation activities.

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<sup>3</sup> See for example UN Security Council, “Report of the Panel of Experts Established Pursuant to Resolution 1874 (2009)”, S/2017/150, February 27, 2017, 72.

<sup>4</sup> See for example James Pearson, Tom Allard, and Rozanna Latiff, “Exclusive - 'Dollars and euros': How a Malaysian firm helped fund North Korea's leadership,” Reuters, April 10, 2017, <http://uk.reuters.com/article/uk-northkorea-malaysia-business-exclusiv/exclusive-dollars-and-euros-how-a-malaysian-firm-helped-fund-north-koreas-leadership-idUKKBN17C0AI?il=0>.

<sup>5</sup> See for example *Chinpo Shipping Co (Pte) Ltd vs. Public Prosecutor*, ‘Judgment’, High Court of the Republic of Singapore, Magistrate’s Appeal No. 9016 of 2016, 2017 SGHC 108, May 12, 2017.

<sup>6</sup> See for example Andrea Berger, “A House Without Foundations: The North Korea Sanctions Regime and its Implementation,” Whitehall Report 3-17 (Royal United Services Institute, June 2017), 16-17.

<sup>7</sup> Emil Dall, Andrea Berger, and Tom Keatinge, “Out of Sight, Out of Mind? A Review of Efforts to Counter Proliferation Finance,” Whitehall Report 3-16 (Royal United Services Institute, June 2016), 9, [https://rusi.org/sites/default/files/201606\\_whr\\_3\\_16\\_countering\\_proliferation\\_finance\\_v2\\_0.pdf](https://rusi.org/sites/default/files/201606_whr_3_16_countering_proliferation_finance_v2_0.pdf). See the relevant recommendations in FATF, “International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation: The FATF Recommendations”, (FATF, February 2012), [http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF\\_Recommendations.pdf](http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf).

## Comments on Pending Legislation and Ideas for Additional Measures

I will offer a few points in response to your legislative discussion draft. I will also offer some ideas for inclusion as you continue to evaluate policy options and craft a strategy for oversight of new sanctions, following their presumed enactment into law.

- A tough approach to focusing on North Korean proliferation networks and facilitators and cutting off North Korea's ability to earn and use foreign currency is appropriate and proportionate to the risk we face today. Now is the time to embrace secondary sanctions authorities and a calculated, targeted strategy for their implementation, to contribute to a broader pressure strategy applied by the United States and international partners on the North Korean regime and its facilitators.
- Within a framework of mandatory secondary sanctions, I strongly encourage the inclusion of meaningful and unconditional waiver provisions to allow the U.S. administration to manage unintended consequences of mandatory secondary sanctions, including avoiding accidentally undermining a broader U.S.-led coalition strategy toward North Korea, a situation where sanctions create a true diplomatic breakdown or look likely to provoke a trade war between the United States and China, for example, or the creation of untenable economic costs for the United States. Waiver provisions should not excuse any proliferation activities but should provide the U.S. administration implementation discretion with regard to partner countries conducting economic activity with North Korea if they make rapid, significant, and repeated progress in reducing trade or financial transactions with North Korea, or if they could otherwise be deemed to be a closely cooperating partner of the United States. This kind of waiver framework could also prescribe escrowing of limited North Korean funds, if permitted under a significant reduction waiver, in monitored accounts from which money may not be transferred to a third country.
- Congress should require the administration to prepare a study on the impacts of different forms of sanctions on large Chinese banks that have dealt either directly or indirectly with North Korea, including its proliferation entities. As the full implications of potential U.S. sanctions or other law enforcement actions on large Chinese banks are not well understood, a rigorous and empirical approach to this matter will guide careful application of sanctions authorities, or the use of other law enforcement actions, and provide useful information to Congress as legislators oversee the U.S. financial pressure strategy on North Korea and consider possible policy options in the future.
- The threat of cutting off International Monetary Fund (IMF) support to countries in which evasion of North Korea sanctions occurs, notably China and Singapore, misses the reality that the countries of greatest proliferation concern are not necessarily aid recipients or the countries with the least capacity and funds for sound sanctions compliance. Also, cutting off IMF support for poorer countries in Africa or elsewhere in Asia that have conducted some business with North Korea, and where limited but concerning evasion may be ongoing, may be less effective than authorizing more funds for technical assistance to support rigorous compliance. Congress should consider ways to direct more money to technical assistance on

proliferation finance and sanctions compliance issues, including through the U.S. Department of the Treasury's Office of Technical Assistance, using funds from illicit finance asset forfeiture or bank fines for violation of sanctions, among other possible sources.

- I caution against new sanctions that specifically go after political leaders of countries in which sanctions evasion occurs. This will be provocative and unconstructive in the diplomatic process of working multilaterally to constrain North Korea's threat. It may create real logistical impediments for the United States in communicating and coordinating with partners on North Korea policy, and it may make it needlessly politically infeasible for these partners to find ways to comply domestically with sanctions on North Korea. The array of U.S. secondary sanctions authorities designed to go after sanctions violators and evaders outside of North Korea, including financial institutions, companies, traders, shippers, insurers, and many others, will certainly be adequate to compel the serious attention of political leaders in countries where evasion is occurring.
- To accelerate the adoption of a rigorous, risk-based approach to proliferation finance at global banks, particularly those in high-risk jurisdictions, Congress can instruct the Financial Crimes Enforcement Network (FinCEN) and the U.S. federal banking regulators to expand supervision of U.S. financial institutions with regard to proliferation finance in risk-based anti-money laundering programs. Banking supervisors should evaluate the adequacy of requirements for covered institutions' foreign subsidiaries, branches, and correspondents to appropriately and similarly apply a rigorous, risk-based approach to identify, freeze, investigate, and report proliferation transactions. FinCEN and the banking agencies should provide proliferation finance typologies, with special emphasis on those used by North Korean proliferation networks, in the new update of the Federal Financial Institutions Examination Council (FFIEC) manual, currently under revision to account for the new Customer Due Diligence rule.
- To complement and support new supervision requirements for U.S. banks, extending to their foreign branches, subsidiaries, and correspondents, on proliferation finance, Congress should facilitate greater information sharing among banks and between the public and private sectors on proliferation finance. Three ways to accomplish this include the following requirements:
  - Instruct FinCEN to regularly report to Congress on the intelligence products it generates from Bank Secrecy Act filings on proliferation finance transactions moving through the U.S. financial system and on its collaboration with law enforcement agencies, the intelligence community, and foreign financial intelligence units to make maximum use of Bank Secrecy Act data. FinCEN should also report on the advisories it issues to financial institutions on proliferation finance activity.
  - Amend Section 314(b) of the USA PATRIOT Act to more explicitly allow banks and other financial institutions authorized under that provision to share information for the purpose of detecting proliferation finance-related activity. Also, amend Section 314(b) to provide safe harbor for certain non-financial institutions, e.g. company formation service providers, to share with banks information about their customers relevant to the detection of terrorism finance, proliferation finance, and money laundering.

- Direct the Treasury Department to consider whether and how current regulations for information sharing, particularly for the purpose of identifying and impeding proliferation finance, may be expanded within the scope of Section 314(b), and to convene external experts and stakeholders in the process, conducting related rulemaking to accomplish any such expansion through a formal regulatory notice and comment process.
- Perhaps the most effective thing that Congress can do to accelerate and enhance the administration's work to analyze North Korean economic and proliferation activity and impose sanctions on those facilitating and enabling it is to give the Treasury and State Departments, and the Intelligence Community, more financial support to expand their work in this area. Such funds could come from law enforcement asset forfeiture or penalties paid by violators of sanctions. More administration experts to do the technical analytical and designations work will rapidly translate into a more muscular ability to use sanctions pressure. More diplomats to explain to foreign banks and regulators the requirements of U.S. sanctions, and the risks of violating them, will also have a direct and meaningful effect on sanctions implementation internationally. Reporting requirements for the administration to explain publicly to Congress its North Korea sanctions strategy are appropriate, and they may play a role in mitigating unintended escalation or miscalculation. However, it would be a detriment to U.S. national security if reporting requirements draw significant time and attention away from the already-stretched experts working in the government to impose and enforce sanctions.

Congress has an important role to play in authorizing and overseeing a strong pressure campaign on North Korea, including financial sanctions and other economic measures, to address the regime's dangerous proliferation activity and defiant provocations. With the direction of responsible U.S. policy leaders, this pressure campaign will maintain the multilateral framework necessary for success and a holistic approach balancing the various tools of economic statecraft with military force and diplomacy. It would be folly to think that sanctions or financial pressure alone, or even primarily, can engineer North Korean willingness to enter diplomatic talks or consider a proliferation moratorium or denuclearization. But, as such economic coercion has the potential to help move North Korea toward a more stable and peaceful path, tough financial sanctions and rigorous bank scrutiny for proliferation finance must now be key policymaker priorities.