Looking inside the shell

Moody's Shell Company Indicator

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Introduction

In an era of exponential risk, threats to an organization's core business don't exist in isolation. Interconnected crime groups, political, and economic challenges combine to create complex problems. Shell companies are a good example of where complex, hidden risk can reside within a counterparty network.

As corporations without significant business assets or operations, shell companies are not illegal — there are legitimate reasons for the existence of shell companies, for example in mergers and acquisitions, use by startups for fundraising, or as part of an initial public offering (IPO).

However, shell companies can be abused and used to process the profits from financial crime. They can help mask illegal activities, with criminals and organized crime groups establishing shell companies to disguise beneficial ownership from financial institutions, law enforcement, and even the public.

Against this background, efforts have been made by businesses and governments to enhance corporate transparency and identify true beneficial owners – this is to help prevent crimes like money laundering, fraud, sanctions evasion, and tax evasion.

Accessing risk-related flags that highlight suspicious company behaviors, may:

1. indicate the existence of a shell company,
2. indicate that a shell company poses a risk of being used for illicit purposes

These flags or risk markers can help organizations target investigations, execute risk analysis, and make decisions with confidence about who they work with.

Moody's Shell Company Indicator — a subscription-based application launched in November 2023 – analyzes data related to more than 485 million companies or entities, and millions of individuals, and it identifies companies that display one or more outlier behaviors, which could indicate a shell company that is being used for illegal purposes.

Shell companies and their role in financial crime

Shell companies can be used to facilitate money laundering related to fraud, bribery and corruption, modern slavery and exploitation, and trafficking of people, drugs, or wildlife, and other types of organized crime.

They can also be instruments used by sanctioned individuals or organizations that are blocked from using the financial system, to find other means to gain access to it. One way is by using a shell company to obscure beneficial ownership i.e. hiding the person who truly owns or controls a business and therefore the person who profits from it.

For financial institutions, businesses, and governments, illegal use of shell companies poses significant regulatory, financial, and reputational risk. Throughout due diligence and investigative processes, Moody's Shell Company Indicator can flag suspicious corporate behaviors that can alert financial crime, risk management, and compliance teams to direct and target their investigations and decision making.

Moody's identifies seven suspicious shell company behaviors

To tackle the complexity surrounding use of shell companies used to commit financial crime, Moody's Shell Company Indicator screens for outlier data - unusual behaviors that might indicate a shell company that it is being misused. In particular, seven flags, or behaviors, can be commonly associated with shell companies. They are:

1. Outlier directorships
2. Mass registration
3. Jurisdictional disparity
4. Circular ownership
5. Outlier age of key individuals
6. Dormancy
7. Financial anomalies

FINDINGS FROM FOUR OF THE SEVEN RISK-FLAGS

1 Outlier age of key individuals

The average age of registered company directors in Moody's' database is 52 years. A director is typically appointed by the company's shareholders or board of directors, and their name is listed on the public register of the company. In many jurisdictions, minors under the age of 18 aren't eligible to be directors.

Moody's Shell Company Indicator has revealed thousands of directors who are as young as zero or older than the world's longest-living person on record.

2 Mass registrations

Mass registration — registering a large number of companies simultaneously or within a short period of time — is another indicator of risk flagged in the solution.

The practice of mass registration of shell companies raises several implications. The volume of companies being registered can suggest an attempt to hide illegal activity or complicate investigations. By spreading assets or transactions across numerous entities, an individual or group can make it more difficult for authorities to trace the flow of money.

In one finding, Moody's Shell Company Indicator pinpointed a firm that registered more than 10,000 companies within its 9-day registration window that had the same company name, director name, and address.

Moody's Analytics

3 Outlier directorships

The Shell Company Indicator also reveals that some individuals are simultaneously serving as directors for an extraordinary number of companies. Mass directorships can suggest illegal activity as they may facilitate corporate opacity used to enable crimes like money laundering. A single individual controlling multiple companies can create complex structures that obscure ownership and financial flows, making it harder for regulators to detect illegal actions. In the most extreme case, Moody's analysis revealed an individual who has 5,751 roles at 2,883 different companies.

4 Financial anomalies

Unusual financial activities or patterns that deviate from the expected norms of legitimate business operations, such as inconsistent profit or revenue compared with industry standards, may not be proof of wrongdoing, but they are indicators that could warrant further investigation. One finding in Moody's Shell Company Indicator reveals that a China-based textiles and clothing manufacturer had revenue of more than $2 billion and only one employee.

Flagging shell company risk

The seven flags associated with common shell company behaviors help build a picture of underlying risk that can be used to direct investigations. These investigations can form part of a third-party risk assessment process, supplier due diligence, customer onboarding, or an ongoing risk monitoring program.

Identifying shell companies and associated risks can also aid government agencies investigating alleged fraud, tax crime, sanctions evasion, money laundering and its predicate offences.

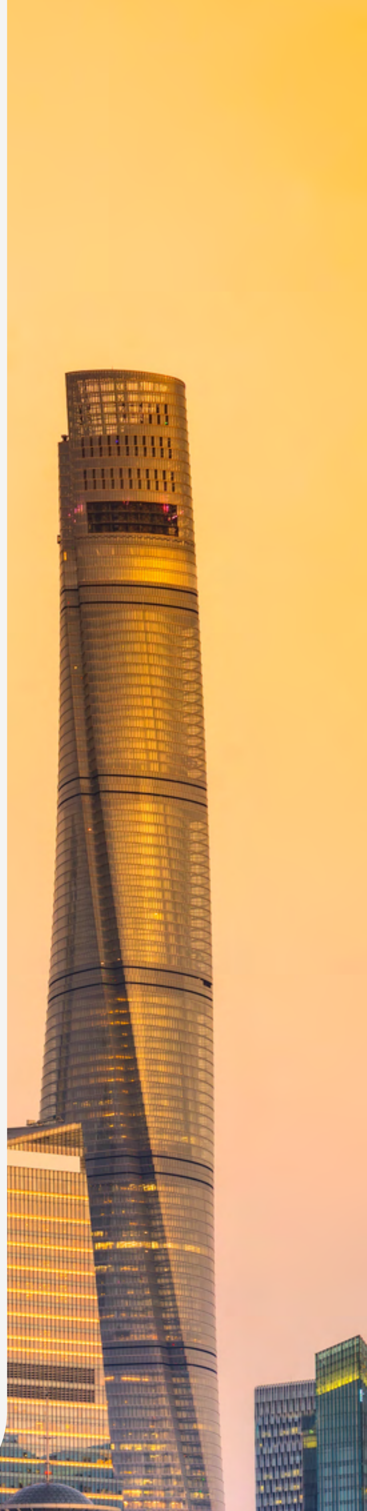
Hidden threats that have historically been difficult to detect, like circular ownership and mass registrations, are brought to the surface by Moody's Shell Company Indicator. The solution empowers organizations to understand risks that might be associated with a customer, supplier, or other third party.

As of November 2023, when all seven behavior patterns are factored in, Moody's Shell Company Indicator raised more than 21 million flags for companies globally.

- **19 million companies raised one flag**
- **More than 900,000 companies raised two or more flags**
- **34,000 companies raised flags for three behaviors**
- **162 firms raised four flags**
- **Six companies raised five flags**
- **No companies (as of November 2023) raised six/seven flags**

The most common double flag combinations are outlier directorship and mass registration combinations. Moody's industry practitioners say that a company that raises two or more flags may be at a heightened risk of being a shell company. And while it shouldn't be inferred that because two flags have been raised for a company that it is a) a shell company or b) involved in illegal practices, it could be a trigger for further reviews.

The UK and China raise the most shell company flags



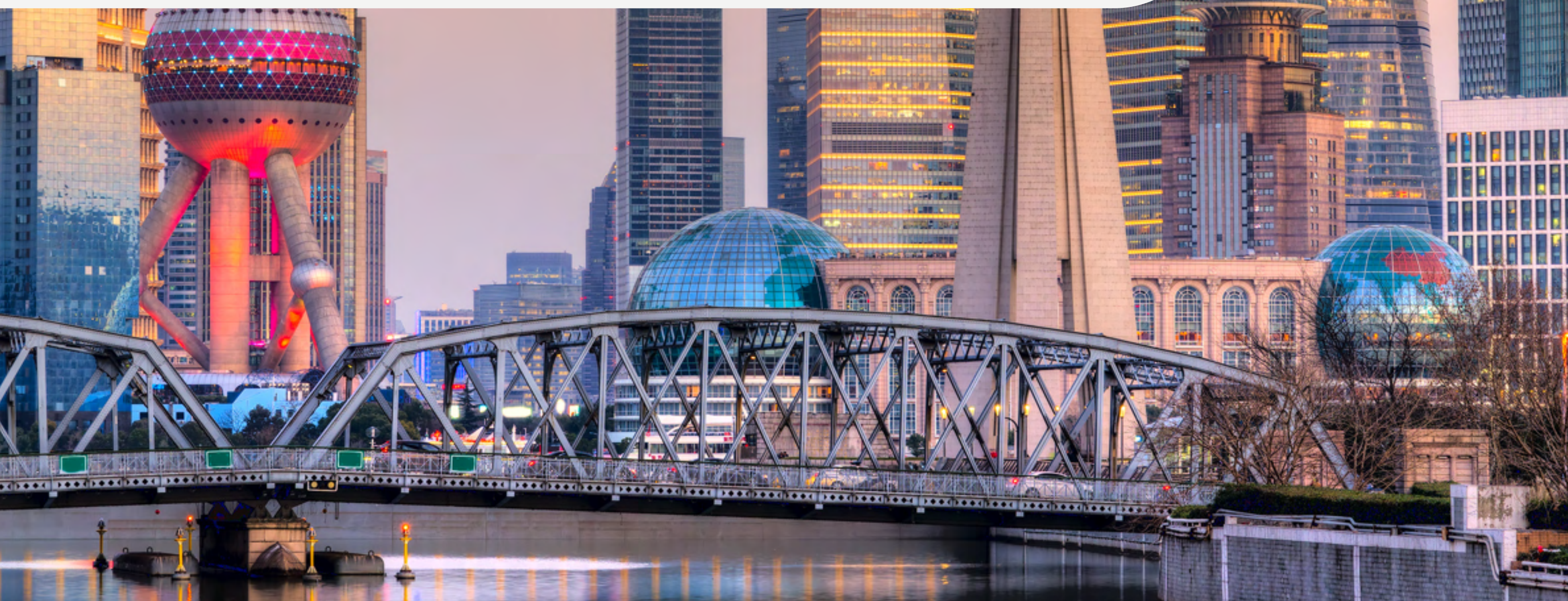
While criminals may use shell companies to launder money, the relationship between money laundering alerts and shell company flags is complex. For example, the US and India top the list of countries triggering money laundering risk alerts. But the United Kingdom, at almost 5 million, triggered the most shell company flags, followed by China with 3.4 million flags, and then the United States in third place with some 1.8 million flags.

Moody's industry practitioners note it is both fast and cheap to set up a company in the UK, which requires only a £12 registration fee. Virtually anyone can own and manage a UK limited company as long as there is one real person who is at least 16 years of age appointed, and the director's address is not a PO Box.

The UK has faced recent criticism for failing to target financial criminals, bringing just 23 cases against bankers and other financial insiders for failing to report money laundering suspicions between 2012 and 2021. However, laws are being introduced to target changes to Companies House, such as the Register for Overseas Entities, and the issue of corporate transparency through legislation i.e. the Economic Crime and Corporate Transparency Act.

While China has 3.4 million flags for shell company risk, Moody's industry practitioners say that to abide by Chinese law and still attract foreign investment, some Chinese firms set up shell companies in tax havens and list them on global exchanges, like the New York Stock Exchange. The offshore shell companies then create contracts with the Chinese operating companies and their owners.

However, sanctions could be another reason China raises the most shell company flags: the US, for one, has numerous sanctions against China, and shell companies can be used to hide beneficial ownership by sanctioned individuals or entities.



Panama's companies have the highest incidence of flags

Countries with the highest percentage of flags per company differ markedly from countries with the largest absolute number of flags. For instance, despite anonymous registrations in Panama dropping by more than half since the 2016 Panama Papers exposé, the nation's companies show the highest flag incidence, with more than 47.3% of firms raising flags.

In close second is Myanmar in Southeast Asia with a 46.6% flag incidence. In October 2022, the intergovernmental Financial Action Task Force (FATF) placed Myanmar on its "grey list" of countries that do not comply with international anti-money laundering standards.

Business services prompts the most shell company flags by sectors

By sector, the business services sector raises the most flags, with approximately 3.6 million total. The wholesale sector follows with 1.5 million flags. And retail comes in third with 1.4 million flags.

Moody's industry practice leads say one possible explanation for why potential shell companies are categorized under business services is that these services are more easily faked. Business services is a broad term and is non-specific regarding the products or services produced/provided. Shell companies can be established solely for the purpose of sending fake invoices in cases related to trade-based money laundering and organized crime, and the term business services provides enough vaguer for cover.

How Moody's can help

A SECTOR LENS ON SHELL COMPANY RISK

Corporates

Fraud is a huge risk and cost to corporations worldwide, and failure to prevent fraud is now, for example, an offense in the UK.

Compliance with sanctions is also an important consideration for corporates, who have a duty to ensure they aren't trading with sanctioned individuals or entities. Plus, following ongoing media reports, most corporates will be eager to prevent reputational damage associated with suppliers in their network found to be involved in offenses such as modern slavery and human trafficking.

Investigations teams are therefore locked in a process of continual review to identify whether companies within their counterparty network – suppliers, vendors, partners, and so on – are legitimate. This includes, for example, uncovering beneficial ownership information and sanctioned individuals. Knowing if there is shell company risk present within a counterparty network can help guide investigations and decision making.

To complete these kinds of due diligence it has sometimes led to manual efforts by risk and compliance teams taking internal data and matching it via online searches, trying to establish beneficial ownership and legitimacy of entities. This is both unreliable and inefficient, but unless automation can be applied to the process, concerns about sanctions, fraud, and other risks outweigh the risk of inefficiency.

Transparency across a supplier/partner network can be hard for corporates to achieve, but Moody's Shell Company Indicator supports transparency, automatically flagging outliers that demonstrate risk. This can aid investigations and form part of wider fraud prevention, supplier due diligence, and risk management activity.

Governments

National governments, departments, and agencies are deeply invested in financial crime prevention, including money laundering and its predicate offenses, with a duty to protect global security, citizens, and economies. Any shell company used to hide illicit practices, beneficial ownership by a criminal or sanctioned individuals, or transfer of money illegally can facilitate fraud, sanctions evasion, tax evasion, human trafficking and more.

Shell Company Indicator provides a new metric by which government departments and agencies can judge a company, it can, for example aid corporate transparency - uncovering beneficial ownership – important when, for example, approving loans and grants or issuing export licenses.

When resources are pressed, having the time to complete investigations can be hard, especially when it's not always obvious where to start looking for risky company behaviors. But the stakes are high. Governments don't want to hold-up commerce, but they also don't want to find themselves embroiled in organized crime.

Shell Company Indicator provides a new perspective for investigations as it clearly points to irregularities that can fuel research more efficiently. Whether part of procurement, checking suppliers of critical infrastructure, due diligence on companies applying for loans/grants/licenses, any potential or associated risk is best uncovered. Automation means the vast amount of data needed to satisfy risk-related checks can be processed and deliver insight. Shell Company Indicator can be used to allocate resources and point investigators in the right direction with a data-driven and risk-based approach.

Financial institutions

In one of the most highly regulated sectors, financial institutions (FIs), can benefit greatly from understanding shell company risk as scrutiny increases through, for example, regulation such as US Beneficial Ownership Information (BOI) reporting and EU ATAD III. It means FIs can look further into a company structure and its purpose, identify cumulative risk markers, and decide whether they meet their business' risk appetite. Shell Company Indicator provides robust evidence to help form decisions during portfolio-wide or individual forensic risk analysis, replacing existing, often time consuming, processes and bringing agility to data-driven decision making throughout customer and third-party lifecycles. It supports a faster and better audit trail towards decision reporting, be it periodic internal reporting, suspicious activity reporting, or client exit for financial crime reasons.

Shell Company Indicator highlights markers of risk for FIs, such as circular ownership shown in the tool using graphics to help remove this blind spot for businesses in the industry. The solution tests for illogical combinations of factors in key data fields, based on normative statistics and flags outliers enabling faster and more informed risk assessment and classification. Companies that flag on several markers bring evidence to analysts to support further assessment of the entity based on previously unconnected risk factors.

Understanding risk across the customer portfolio is a continuous/perpetual process and Shell Company Indicator provides a picture of risk at any time, bringing consistency and efficiency in the identification of changing risk factors through data mining throughout an engagement with clients and third parties. FIs are required to react increasingly quickly, treating all parties fairly, protecting actors in markets, while guarding access to it. Exposure to and failure to prevent, direct or indirect, international sanctions circumvention, front companies, grey economy service providers, tax crimes, and fraud has never been more topical for FIs than today in order to protect the integrity of the financial system. Shell Company Indicator reveals previously hidden markers of risk through data, which helps target current and evolving typologies of financial crime, enabling FIs to continuously monitor the effective mitigation of out-of-appetite exposure in their portfolios.

Summary

The global and pervasive issue of shell companies being used for illicit activities like money laundering, terrorist financing, sanctions evasion, and tax crimes continues to pose a significant risk to the global economy. Governments are driving scrutiny, leading with regulations that include the US Corporate Transparency Act, Companies House Register of Overseas Entities, and new EU legislation to prevent the misuse of shell entities for tax purposes. However, with $1.6 trillion laundered each year, the scale of the problem is enormous.

With the advent of tools like Moody's Shell Company Indicator, governments and businesses can better identify shell companies and scrutinize suspicious behaviors across a global network. It helps develop more accurate investigations and effective measures to thwart beneficiaries of financial crime.

Considering the exponential risk posed by the number of companies that raise flags, the global and complex nature of financial crime, and the diversity in flags raised across jurisdictions, the challenges posed by shell companies would be impossible to address without automation.

While the number of companies flagged for shell company behavior has declined since the Panama Papers exposé, the persistently high number of shell companies, especially in countries like the UK and China, means tools that support investigation and enable due diligence should be leveraged wherever possible.

The fight against financial crimes that involve shell companies requires international cooperation, government and corporate vigilance, and the continuous refinement of detection tools like Moody's Shell Company Indicator.

Risky business? Seven indicators of shell company risk

Moody's has published new research into global shell company risk via an interactive data story. Please visit the data story for unique facts, figures, and insights.

https://www.moodys.com/web/en/us/about/insights/data-stories/kyc-innovation-shell-company-indicator.html

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