Understanding the Financial Crime Risks of Trade

Standard Chartered

In recent years, regulatory guidance and industry publications have reiterated that Trade is a high-risk product from a money laundering perspective.

FATF, Trade Based Money Laundering (June 2006): "The international trade system is clearly subject to a wide range of risks and vulnerabilities that can be exploited by criminal organisations and terrorist financiers. In part, these arise from the enormous volume of trade flows, which obscures individual transactions; the complexities associated with the use of multiple foreign exchange transactions and diverse trade financing arrangements; the commingling of legitimate and illicit funds; and the limited resources that most customs agencies have available to detect suspicious trade transactions."

FCA, Banks' control of financial crime risks in trade finance (July 2013): "The misuse of international trade finance is one of the ways criminal organisations and terrorist financiers move money to disguise its origins and integrate it into the legitimate economy. The complexity of transactions and the huge volume of trade flows can hide individual transactions and help criminal organisations to transfer value across borders."

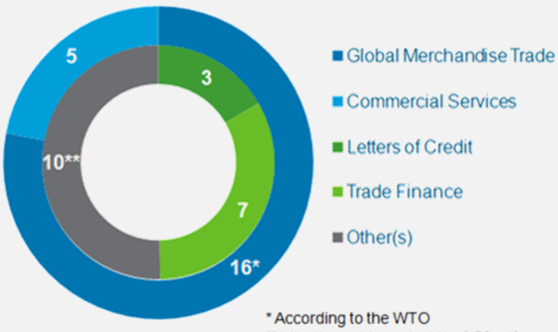
Banks across the globe are reacting to the financial crime risk posed by trade activity by seeking to enhance their controls and oversight of these transactions. But are Trade and Trade Finance uniformly high risk? Let's take a closer look.

Trade risk is not so black and white

Trade activity is not homogenous, but a varied, multi-layered and complex combination of actions, involving people, goods, paper and money in many different variations. Similarly, Trade Finance, as a service, is multi-faceted with many different products available to both exporters and importers. We must therefore consider whether the financial crime risk associated with trade might be equally nuanced.

Global Merchandise Trade (trade in goods, not services) in 2015 amounted to US$16 trillion according to the World Trade Organisation, which was a decrease of 13% from the prior year (largely due to a global fall in commodity prices). Commercial Services contributed a further US$4.5 trillion. However, the Bank for International Settlements reports that Trade Finance directly accounts for approximately one third (or US$7 trillion in 2015) of total global trade, with letters of credit covering a further one sixth (or US$3 trillion).

Global Trade in 2015: US Trillions



* According to the WTO
** http://www.bis.org/publ/cgfs50.pdf

Burglar-proofing your home

We can safely assume that money launderers, in general, would like their movement of funds to attract the least scrutiny possible, i.e. with an absolute minimum of involvement of third parties outside of their criminal organisation. That is therefore the layer of global trade that both bears the greatest financial crime risk, and is also the most difficult to control.

Preventing and detecting financial crime is about the controls and checks that Banks have in place in their operational processes. These aren't only detective in nature, but also have a preventative impact. The more controls a Bank has embedded in its operational processes, the less attractive it will be to criminal organisations and individuals.

Let's compare to a would-be burglar: you will never make it impossible for a burglar to enter your home - a determined or skilled burglar will always find a way. What you instead focus on is making it so time consuming or difficult that the burglar would rather go somewhere else.

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Generally speaking, from the late 1990s until the 2008 financial crisis, the focus of many Banks was to streamline and polish their operations in order to satisfy their customers' demands for speed and efficiency. This led some banks to focus on centralised and efficient operations (in order to expedite turnaround times) to the detriment of control effectiveness; thereby rendering them more attractive for criminal organisations than smaller, more specialised banks with localised processing and more targeted controls.

Another factor is the products that banks provide to their clients. When we look at Trade products in more detail, we can see that some of these are relatively unlikely to attract the attention of money launderers. This is, in part, due to the document requirements built into these products.

1. Open Account Trade products, for example, all involve financing by a Bank. That is, either the buyer or the seller requires funding for their trade activities. Since money launderers are, by definition 'long in money', the lengthy process of applying for credit facilities, with the added scrutiny from various bank departments, is not only unnecessary, but also unwanted. The exception to this is where having credit facilities would be part of the 'disguise' put in place to provide the criminal organisation with a smokescreen of respectability. Open Account products also have varying levels of extra requirements depending on several factors, such as creditworthiness of the client or complexity of the transaction. These requirements would include, but not be limited to, the submission of (copies of) invoices or transport documents.

2. Documentary Trade products introduce multiple hurdles to criminals intending to misuse them. Banks have to process these transactions according to a standardised set of rules involving checks on the compliance of the associated documents with the terms of the letter of credit (Uniform Customs and Practice (UCP) of the ICC). This requires the seller to provide an internally consistent set of documents, more often than not including a Bill of Lading, a document that is difficult to fake and easy to check. Even Documentary Collections, while not necessarily undergoing a check by the bank, will still require document consistency to make cover for the ever present Sanctions and increasing (Anti-Money Laundering) AML checks. These control requirements make documentary credit attractive mainly for money flows to and from countries with export or import controls, requiring proof of the goods actually entering or leaving the country.

Understanding product risk

The Standard Chartered Bank (SCB) proprietary Product Risk Assessment involves an assessment of over 400 products and analyses multiple characteristics of products' features. This allows the Bank to determine a 'Low' to 'Medium' inherent risk score for AML and Sanctions risk for open account trade finance and documentary trade products.

This is due to the significant level of transparency that the Bank has over its client and over the end-to-end transaction. The Product Risk Assessment also informs us that the highest risk product linked to Trade is the cash payments supporting open account trade activity. The second highest-risk rated product is Financial Institution (FI) trade financing. This is where a Bank provides finance to another Bank to support its Trade Finance activities. This is similar to correspondent banking, other than the fact that the FI requiring financing will provide full details of the underlying Trade transaction, usually in a MT799 message. Therefore, the purpose of the transaction is far more transparent than a correspondent banking payment. Additionally, the underlying documents can be obtained as necessary.

Surveillance

While cash management products, such as payments, have been subject to widespread automated detection scenario surveillance for many years, this approach is likely to be less successful in Trade Finance.

An alternative approach is more targeted monitoring where known risk factors such as related parties, tax-free zones, high-risk corridors, high-risk goods etc. which have been identified as potentially suspicious by a well-trained Trade Operations function are used to 'data-mine' historical transactions looking for similar traits and also, connections between otherwise unrelated parties. Additionally, the high-risk indicators identified through this process can then be incorporated into the training of relevant staff; supporting a continuous improvement loop.

New joint guidance on standards for the control of financial crime risks associated with Trade Finance activities was developed by the Wolfsberg Group, BAFT and ICC in January 2017, and supports this view. The guidance can be found here.

"As a significant trade bank with a presence in the world's largest industrial and commercial centres, we have the responsibility to our clients and society as a whole to play a leading role in the detection and prevention of financial crime, which includes contributing to the development of AML techniques in the industry."

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