Money Laundering bulletin

The monthly briefing service for anti-laundering specialists

The 41st FATF Recommendation: why preventive measures targeting trade-based money laundering should reach beyond banks

It is an open secret, writes **Ross Delston** [1], that the Financial Action Task Force (FATF), is considering a new recommendation on trade-based money laundering. Its intentions were telegraphed by the publication in June 2006 of its monograph entitled "Trade Based Money Laundering" (the "FATF Report").

Whether the FATF will add a 41st Recommendation to its current 40, or, more likely, a tenth recommendation to the nine Special Recommendations on Terrorist Financing, has yet to be announced. In my view, adding a new recommendation is not only a good idea, but also FATF should go further than it has in the past. In order to be effective, any new recommendation on trade-based money laundering should encompass not only financial institutions and designated non-financial businesses and professions (DNFBPs) [2] but also companies involved in the export or import of goods, including firms transporting or arranging for the transport of those goods, such as freight forwarders, shippers and air couriers. And since most of the largest global industrial companies are also exporters and importers, any such proposal would encompass a whole new category of non-financial companies that may not be paying close attention to the FATF 40+9 currently.

If adopted, this would require governments to take a number of actions, to ensure, among other things, that exporters and importers conduct customer due diligence, keep records and file suspicious activity reports (SARs), just as financial institutions and DNFBPs must do. And in the US, this would also include the four pillars of an AML program under *section 352* [3] of the *USA PATRIOT Act*: internal policies, procedures and controls; the designation of an anti-money laundering (AML) compliance officer, an ongoing employee training programme, and an independent audit function to test the AML programme.

What is trade-based money laundering?

The FATF Report defines it as the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimise their illicit origins. In practice, this can be achieved through the misrepresentation of the price, quantity or quality of imports or exports. Moreover, trade-based money laundering techniques vary in complexity and are frequently used in combination with other money laundering techniques to further obscure the money trail. [4]

A subset of activities covered by the term 'trade-based money laundering' are those relating to trade finance, primarily activities of banks in financing international trade. This includes the issuance and confirmation of letters of credit for exports and imports, making loans to companies for the export or import of goods, as well as providing guarantees or stand-by letters of credit and pre-export financing, assisting companies in the collections process, discounting drafts and acceptances, and offering fee-based services such as credit and country information on buyers. [5]

Red flags for trade-based money laundering [6]

How can firms recognise trade-based money laundering sufficiently to form suspicions worth reporting? The US banking regulators and the FATF have provided some clues:

1. Items shipped that are inconsistent with the nature of the customer's business (eg, a steel company that starts dealing in paper products, or an information technology company that starts dealing in bulk pharmaceuticals).
2. Customers conducting business in high-risk jurisdictions.
3. Customers shipping items through high-risk jurisdictions, including transit through non-cooperative countries. [7]
4. Customers involved in potentially high-risk activities, including activities that may be subject to export/import restrictions (eg, equipment for military or police organisations of foreign governments, weapons, ammunition, chemical mixtures, classified defence articles, sensitive technical data, nuclear materials, precious gems, or certain natural resources such as metals, ore and crude oil).
5. Obvious over- or under-pricing of goods and services.
6. Obvious misrepresentation of quantity or type of goods imported or exported.
7. Transaction structure appears unnecessarily complex and designed to obscure the true nature of the transaction.
8. The shipment does not make economic sense (for example, the use of a forty-foot container to transport a small amount of relatively low-value goods.) [FATF Report]
9. The size of the shipment appears inconsistent with the scale of the exporter or importer's regular business activities. [FATF Report]
10. The type of commodity being shipped appears inconsistent with the exporter or importer's regular business activities. [FATF Report]
11. The transaction involves the receipt of cash or payment of proceeds (or other payments) from third party entities that have no apparent connection with the transaction. [FATF Report]
12. The transaction involves the use of front (or shell) companies. [FATF Report]
13. Shipment locations or description of goods not consistent with letter of credit.
14. Documentation showing a higher or lower value or cost of merchandise than that which was declared to customs or paid by the importer.
15. Significantly amended letters of credit without reasonable justification or changes to the beneficiary or location of payment. Any changes in the names of parties should prompt additional Office of Foreign Assets Control (OFAC) review.
16. Significant discrepancies appear between the description of the commodity on the bill of lading and the invoice. [FATF Report]
17. Significant discrepancies appear between the description of the goods on the bill of lading (or invoice) and the actual goods shipped. [FATF Report]
18. Significant discrepancies appear between the value of the commodity reported on the invoice and the commodity's fair market value. [FATF Report]

Implications for financial institutions, exporters and importers

Why shouldn't financial institutions and DNFBPs, banks in particular, do all the heavy lifting, as the FATF 40+9 generally require? The answer is clear: it just won't work. Even a cursory examination of the red flags set forth above reveals exactly how unworkable it would be to assign banks the primary role for this purpose.

At least half of the 18 red flags require quite a bit more than documentary review to uncover suspicious or unusual activities or transactions: numbers 1, 5, 6, 8, 9, 13, 14, 17 and 18 would require active monitoring by a party involved in the exportation, importation or transport of goods in order to determine that something wasn't right.

For example, red flag 5 refers to obvious over- or under-pricing of goods. How is a bank to know what the correct price of goods being exported or imported should be? Red flag 17 refers to significant discrepancies that appear between the description of the goods on the bill of lading and the actual goods shipped. How would a bank ever discover this, except by accident?

Conclusions

It seems obvious that the FATF approach of requiring the usual suspects – banks and other financial institutions, along with DNFBPs – to take on preventive measures by themselves won't work very well in the case of trade-based money-laundering.

Nor will this be painless or easy to accomplish. According to Oxford Analytica, world ports handled some 452m twenty-foot containers in 2006, a number which is rising every year. [8]

The stakes are also higher since trade-based money laundering can involve not only predicate crimes [9] such as narcotics trafficking, human trafficking and terrorist financing, but also the same techniques used in trade-based money laundering could be used to disguise logistical support for terrorist activities such as the movement of weapons of mass destruction (WMD)[10] or the materials to make them.

Given the significance of this issue, and the inability of banks to respond in an effective manner, shouldn't exporters, importers and those involved in the transportation of goods take on the bulk of these responsibilities?

The answer is self-evident – now all that remains is for the governments who make up the membership of FATF, starting with those who have suffered from terrorism and its threats, to take the lead in addressing this issue.

Notes

1. While any mistakes in this article are those of the author alone, he is grateful to John J. Byrne, CAMS, Regulatory Relations Executive – Global Compliance & Operational Risk, Bank of America, for pointing out the anomalies between trade-based money laundering red flags and the ability of banks to mitigate the risks posed by this type of money laundering, during the course of a January 2008 web seminar we did on this subject.
2. 'DNFBPs' cover five categories: lawyers, notaries and accountants when engaged in commercial transactions for clients; dealers in precious metals and precious stones; gambling casinos; real estate agents; and company and trust service providers when engaged in a range of services. See FATF Recommendations 16 and 24, the related Interpretative Notes, and the Glossary for more on DNFBPs.
3. *Section 352* amends the *Bank Secrecy Act* and is codified at 31 USC Section 5318(h).
4. FATF Report, Executive Summary.
5. See the US FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual (2007) (hereinafter the "BSA/AML Examination Manual"), p241, for an excellent discussion of trade finance operations.
6. The red flags are from the BSA/AML Examination Manual, Appendix F-5, unless identified as from the FATF Report, p24 of which contains a list of red flags.
7. There are no countries currently on the FATF Non-Cooperative Countries and Territories List.
8. "Ship containers, potentially used by terrorists, may get more screening," posted in Thehill.com (12/04/07).
9. The underlying crimes to the offense of money laundering are called 'specified unlawful activities' under US law, as defined in 18 USC Section 1956(c)(7).
10. See the article referred to in note 8 above.

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