Defeating Trade Based Money Laundering Rules Using Human Intelligence

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Executive Summary

Trade-Based Money Laundering (TBML) persists as a global threat despite decades of understanding guided by the highest of AML professional bodies. The FATF, for example, defines TBML as a process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimise their illicit origin. It particularly cautions against criminals using various trade data misrepresentations when conducting international transactions.

The global data behind this perspective, however, is stained with inaccuracies that misguide financial institutions' TBML mitigation measures. Consequently, efforts to date have proven inadequate and banks are dealt with a series of challenges that they are unable to decipher with the existing regulatory guidance. Criminals, on the other hand, enjoy little disruption to their illicit operations.

A new approach is needed to address this paradox.

At **Vortex Risk** we have created a **Risk Analysis Merging Platform (RAMP) methodology** that looks at TBML from the perspective of rationally thinking criminals who carefully mitigates the risk of alerting authorities to their nefarious activities.

RAMP can empower banks to proactively discern legitimate customers from those tainted with crime, support their customers with innovative trade products, and above all disrupt criminal modus operandi in accordance with the regulatory ‘risk-based approach’ (RBA).

The Trade-Based Money Laundering Riddle

‘TBML is the most prominent laundering method, least understood, and covers much broader banking products than anybody gives it credit for’.

What is Trade-Based Money Laundering?

Trade-Based Money Laundering goes beyond the Financial Action Task Force (FATF) definition that stresses a process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimise their illicit origin.

TBML is in fact an umbrella term encompassing all types of money laundering techniques utilising a series of '**transfers**' and '**purchases**' [1] designed to distance a criminal from their dirty money.

The methods of doing so vary in complexity. They depend on the purpose, the sums involved, and the frequency with which the illicit funds must be laundered.

Small and infrequent sums can be commingled effectively with the legitimate business activity of a small retail shop set up at a temporary location. Alternatively, a criminal with a large illicit income can invest in a front business in an industry that is rather difficult to police or that the criminal understands well.

Large and frequent flows may also need sustainable schemes maintained by lawyers, accountants, or financial advisors. Individuals wishing to avoid currency restrictions may need documented trade finance products such as letters of credit, documentary collections, and guarantees to provide a legitimate cover for the transfer of funds.

Of critical importance is that financial transactions are not required to facilitate TBML. Criminals can simply choose to exchange goods, services or favours as part of a barter trade.

''transfers' and 'purchases' is a term first defined in the book; ***The War on Dirty Money*** to better explain money laundering as no longer a process of placement, layering and integration.

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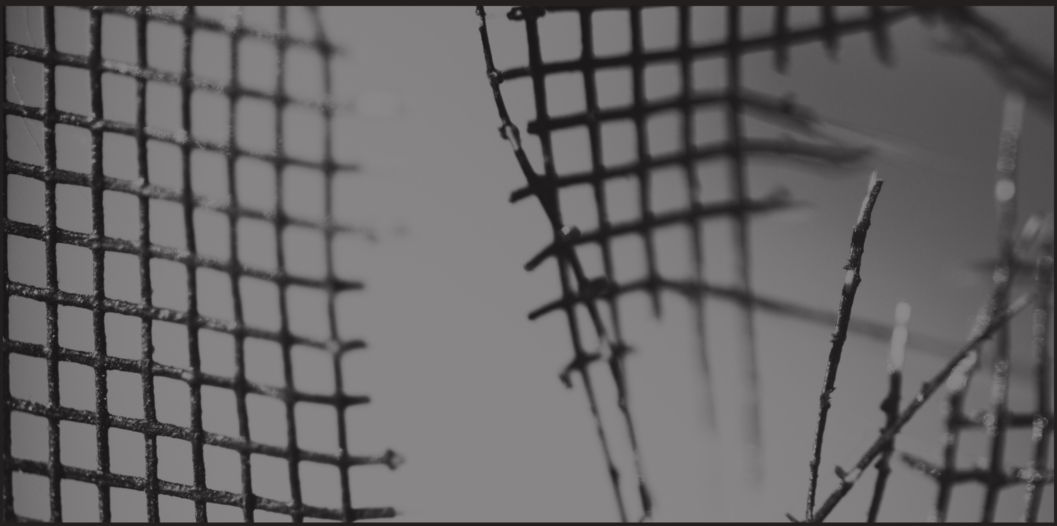
Why Should We Care?

Modest estimates of Illicit trade flows range from **$2.3 trillion to $2.9 trillion per year**.[1] Studies have revealed that 24% of this amount represents the laundering of domestic funds, 16% of foreign criminal money, and 60% is criminal proceeds passing through before reaching their final destination.[2]



Critical to understanding TBML is how smaller countries are mainly used to funnel funds, while larger countries face the biggest challenge in the laundering of domestic crime proceeds.[3] Once criminals exhaust their domestic money laundering approach, it is not uncommon for them to choose a country with geographical proximity, strong trading or community links, common language, colonial ties, and other attractive measures including GDP per capita, bank secrecy, or government attitude towards money laundering.

Major economies like the UK and the US tick a lot of those boxes, therefore, they are widely considered to be responsible for processing most of the global illicit trade flows.

[1] Walker, J. (1999). How big is global money laundering? *Journal of Money Laundering Control, 3*(1), 25-37. Doi: 10.1108/eb027208

[1], [2], [3] Ferwerda, J., Saase, A., Unger, B., and Getzner, M. (2020). Estimating money laundering flows with a gravity model-based simulation. *Scientific Report, 10*(1), 18552. Doi: 10.1038/s41598-020-75653-x

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Current Rule-Based TBML Mitigation Strategies

‘Harsh compliance expectations mainly benefit professionals who increase their money laundering fees depending on the obfuscation complexities needed. Banks tasked with detecting the schemas struggle to understand new techniques and inevitably file unintelligible suspicious activity reports‘.

The Regulatory Red-Flag Approach

The most widely used TBML risk mitigation guidelines originate from the FATF – the global policymaker in combatting money laundering and terrorism financing. FATF describes TBML as predominantly associated with complex international trade transactions involving goods import/export data misrepresentations such as over/under invoicing, over/under shipment, phantom shipments, and falsely declared product quality.

In response, various supervisory bodies across the globe have **issued hundreds of red-flags** and risk indicators to help their own regulated sectors mitigate TBML.

Most recently, the FATF and Egmont Group of FIUs published an updated report on Trade-Based Money Laundering: Trends and Developments[1] followed by another that consolidated risk indicators into four main groups:

- the structure of the business
- trade activity
- trade documents and commodities
- account and transaction activity.[2]

The FATF recommends that financial institutions, in particular, should assess the adequacy of their policies, procedures, and systems for managing those TBML indicators on higher-risk trade-related banking products, geographies, and customers.

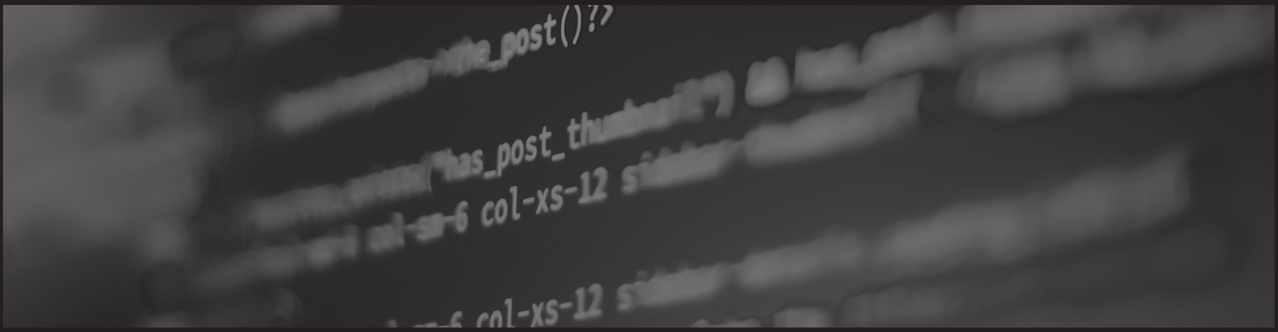
[1] FATF. (2020). *Trade-based Money Laundering Trends and Developments.* FATF. https://www.fatf-gafi.org/en/publications/Methodsandtrends/Trade-based-money-laundering-trends-and-developments.html

[2] FATF. (2021). Trade-Based Money Laundering Risk Indicators. FATF. https://www.fatf-gafi.org/media/fatf/content/images/Trade-Based-Money-Laundering-Risk-Indicators.pdf

Banks‘ Reactive Compliance

The Wolfsberg Trade Finance Principles[1] publication is considered to be the primary guide for the banking industry on how best to apply the current regulatory TBML approach. The principles advise that in the spirit of compliance, **banks ought to seek red-flags and risk indicators** across businesses trading goods internationally where misrepresentation of trade data can be observed – mainly on highly documented trade finance products.

Since the regulators perceive those products as high-risk, most banks purposefully opt for a strict customer selection and due diligence process. Clients are asked to provide documentation on their business validity, the controlling parties, and what trade behaviours a bank is expected to finance. Yet only those capable of evidencing their business practices and meeting credit requirements ever get approved. To ensure continuous compliance, **transactions undergo detailed reviews** by at least two highly trained trade operators. Should TBML risk indicators be found during this process, compliance departments conduct further checks using external data sources if appropriate.



Since open account transactions conducted via simple wire transfers are not accompanied with robust documentation, like with trade finance products, Wolfsberg specifically advises banks to then follow their standard know your customer (KYC), customer due diligence (CDD), transaction monitoring, and watchlist and sanctions screening policies.[1] These measures are recommended both on a bank's own direct and indirect customers, depending on the institution's risk appetite.

[1] Wolfsberg. (2019). The Wolfsberg Group, ICC and BAFT Trade Finance Principles. The Wolfsberg Group. https://www.wolfsberg-principles.com/sites/default/files/wb/Trade%20Finance%20Principles%202019.pdf

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TBML Compliance Paradox

‘The TBML red-flags and risk indicators generally alert on legitimate customers whose trades are held-up for compliance checks with some customers even being subject to de-risking‘.

Undisturbed Criminals

Research has uncovered that the majority of TBML risk indicators are perceived by banks as **too vague** to help recognise legitimate customers from those associated with crime.

If suspicious trade activities are found, they tend to trigger on inexperienced criminals – like those who chose highly transparent trade finance products or have made errors in trying to cover up their activities. Other triggers may involve clients trading in high-risk dual-use goods, attempting to circumvent currency restrictions, or whose transactions violate a bank's internal risk appetite policies.

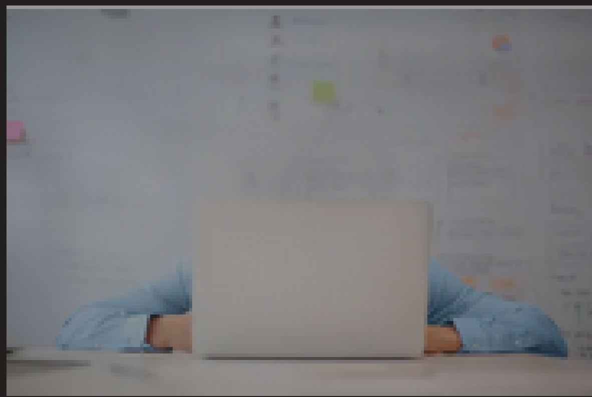
The vast majority of money launderers rarely stand out from the crowd. They understand banks' blind spots. Therefore, they are more likely to trade in services rather than goods, conduct domestic trade before considering international transactions, maintain low-risk KYC profiles, and commingle a wide variety of money laundering methods.

Banks point out that the rule-based compliance system negatively influences their work on trying to mitigate money laundering. **Banks do not feel empowered with knowledge on how TBML is being done** in practice.

As a result of the current TBML regulatory strategy, a compliance paradox has been created where banks apply a risk-based approach (RBA) to mitigate the threat of receiving regulatory punishments (huge fines) rather than being abused by criminals.

Frustrated Customers and Stalled International Trade Growth

Banks take the possibility of regulatory action very seriously. For most, the consequences are significantly greater than paying a substantial fine. Non-compliance with regulatory expectations can equally result in reputational damage, high remediation and legal costs, business disruption, revenue loss, and declining productivity.



Struggling to stay competitive is another negative consequence. Smaller financial institutions **spend nearly 10% of their total expenses on meeting compliance obligations.**[1] This financial obligation inevitably results in increased customer fees, friction in banking services, and less budget allocated for loans and innovation.

Unmanageable compliance costs strongly influence banks' obligations to various stakeholders, forcing them to make problematic cost/benefit decisions. **Many choose to exit clients, sectors, and jurisdictions that cost too much to monitor for TBML risk indicators.** However, such practices are still exploited by new competitive trade finance entrants not falling under that same regulatory scrutiny as banks.

It is the small and medium enterprise (SMEs) that experiences de-risking measures most. A vast majority will find their trade finance product applications rejected, leaving them to seek less transparent trade payment methods or financial service providers. The consequences were observed in the 2023 Global Trade Finance Gap, Growth, and Job Survey results. According to the study, the global trade finance gap is 47%, up since 2020 reaching $2.5 trillion in 2022.[2] Banks point to challenging AML measures, such as Know Your Customer obligations on SMEs or monitoring trades with high-risk jurisdictions, as a significant cause behind the widening gap.

[1] Wilkes, C. (2020). A Case for Reforming the Anti-Money Laundering Regulatory Regime: How Financial Institutions' Criminal Reporting Duties Have Created an Unfunded Private Police Force. *Indiana Law Journal, 95* (2), 649 -682. Doi: https://www.repository.law.indiana.edu/ilj/vol95/iss2/7

[2] ADB Briefs. (2023). *2023 Global Trade Finance Gap, Growth, and Job Survey*. ADB Briefs. https://www.adb.org/sites/default/files/publication/906596/adb-brief-256-2023-trade-finance-gaps-growth-jobs-survey.pdf

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Correcting the Paradox

'The ideal solution would empower banks with the knowledge to adopt TBML preventive measures commensurate with how they experience the problem. In essence, a solution providing banks with a methodology on how to move from costly rule-based compliance to an effective risk-based approach'.

TBML Knowledge is the Cornerstone of the Risk-Based Approach (RBA)

The FATF describes the risk-based approach as the best regulatory initiative designed to help countries, competent authorities, and banks adopt a more flexible set of anti-money laundering and terrorism financing (AML/CTF) measures that target their resources more effectively in accordance with the nature of risks they face.[1] The FATF further stresses that the **RBA is not a “zero failure” approach**. What this means is that despite reasonable measures to counter the risks, banks might still be used for money laundering and terrorism financing purposes[1].

The explanation by the FATF demonstrates that countries whose financial services sectors are emerging or whose legal, regulatory, and supervisory frameworks are still developing should not use RBA. FATF instead recommends applying more prescriptive AML/CTF requirements until the sector’s AML/CTF understanding and experience are strengthened to allow for credible risk decisions.[1] What this means is that the rule-based regulatory approach suits countries at the initial AML stage, and as their financial services’ understanding of money laundering matures, they can gradually move towards the RBA. Unfortunately, the FATF also points out that many countries, competent authorities, and banks **still face substantial challenges in understanding the AML/CTF risk** they face[2], particularly regarding TBML – a method of money laundering widely considered as the most prevalent.

[[1] FATF. (2014). Guidance for Risk-based Approach. The Banking Sector. FATF. https://www.fatf-gafi.org/media/fatf/documents/reports/Risk-Based-Approach-Banking-Sector.pdf

[2] FATF. (2022). Report on the State of Effectiveness and Compliance with FATF Standards. FATF. https://www.fatf-gafi.org/en/publications/Fatfgeneral/Effectiveness-compliance-standards.html

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Introducing a Revolutionary TBML Detection Methodology

At Vortex Risk we have taken the time to understand TBML to a depth never attempted before. Our unique knowledge powers **RAMP** to help banks proactively spot TBML vulnerabilities and enablers beyond those contained in the regulatory guidelines.

RAMP, in the simplest terms, can be compared to **a constantly expanding roadmap of TBML choices** that criminals make to distance themselves from the dirty money. The map highlights steps, actions, tools, services, and parties that criminals might utilise depending on their money laundering needs. It also explains the criminal reasoning behind their choices, the risks to those involved, and the warning signs beyond what the red flags are ever likely to capture.

The **human intelligence behind Vortex Risk** can enable banks to:

- Uncover TBML offenders and **reduce reactive compliance spending** on assessing false positive alerts generated by legitimate customers.
- Feel empowered to **innovate with new trade finance offerings** tailored to banks' current and prospective customers.
- **Evidence the robust RBA** that puts banks in a leading position to refocus regulatory attention on criminal enterprises and away from banks whose doors are closed to dirty money.

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Keen to know more?

This is an opportunity for you to 'stand on the shoulders of giants' and be the world's leading bank at delivering a true Risk Based Approach to Trade-Based Money Laundering.

Dr. Nicholas Gilmour
Vortex Risk Co-Founder
LinkedIn

Dr. Mariola Marzouk
Vortex Risk Co-Founder
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If you are keen to understand the benefits of **the Vortex Risk RAMP solution** and become our trusted partners in transforming how we approach mitigating TBML, get in touch by emailing us at **info@vortexrisk.com**

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