The Unintended **Risk-Averse** Compliance Approach to Trade-Based Money Laundering

VORTEX RISK

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Executive Summary

The risk-based approach (RBA) to Trade-Based Money Laundering (TBML) has triggered an unintended risk-averse response by banks that felt pressured to provide a ‘magic fix’ to the very prevalent and greatly under-researched problem.

This risk-averse response can be explained by the 'crying wolf’ paradox that arises due to the excessively high fines for non-compliance with regulatory expectations. To minimise the regulatory risk, banks simply choose to err on the safe side and report transactions that are less suspicious but fit into the prescriptive TBML red flags and risk indicators; namely those on trade finance products.

To correct this risk-averse approach, the regulators must stop treating banks as ‘ignorant children who have to be taught a lesson’ and trust in their abilities to make sound risk-based decisions that align with good social outcomes.

At **Vortex Risk** we have created a solution to help with the 'crying wolf’ paradox. Our **Risk Analysis Merging Platform (RAMP) methodology** empowers banks with robust TBML knowledge to drive their risk-based decisions. **RAMP** differs from the rule-based approach as it expands beyond the red flags to include the perspectives of rationally thinking criminals who mitigate the risk of getting caught by exemplifying legitimate customers who rarely trigger any suspicious events.

“The way that we’re spending money is not curbing money laundering. Yes, we report some stuff but it’s not meaningful. The approach is counterproductive. The system is working against itself.”

What is The Risk-Averse Compliance Approach?

The risk-averse compliance approach to mitigating Trade-Based Money Laundering (TBML) is an unintended consequence of the regulatory shift from the rules-based system to the risk-based approach (RBA) - in the hope that banks will magically fix the problem.

The challenge in addressing TBML, however, is that the regulators continue to ignore the most glaring obstacle; both public and private sector entities have no real understanding of how trade is abused for money laundering in practice.

> ***"Policymakers don't want to hear about TBML because enforcement is complicated, it's expensive and they want that magic fix and the magic fix doesn't really exist".***

The RBA principles give banks the flexibility to '*identify, assess, and understand the money laundering and terrorist financing risk to which they are exposed, and to … apply preventive measures that are commensurate to the nature of risks…*'[1, p.6]. Yet, the FATF advises countries that in situations where their regulated institutions lack the knowledge and confidence to identify and manage money laundering risks effectively, to follow '*a more prescriptive regulatory approach until their understanding and experience are strengthened*'.[1, p.8].

Since TBML is widely considered the least understood and most under-researched money laundering type, banks - in an attempt to meet RBA expectations - simply play safe by applying very risk-averse controls on trade finance products that the regulators openly associate with TBML.

[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

“Trade-Based Money Laundering is much, much wider than money laundering through trade finance… Trade-Based Money Laundering is any money laundering that is effective through any trading activity between parties, and that can be through any product.”

Why The Regulatory Focus on Trade Finance?

The global regulatory focus on trade finance products as the main conduit to Trade-Based Money Laundering links back to the FATF's TBML definition and the associated risk indicators.

The FATF describes TBML as predominantly related to complex international trade transactions involving import/export data misrepresentations such as over/under invoicing, over/under shipment, phantom shipments, and falsely declared product quality.

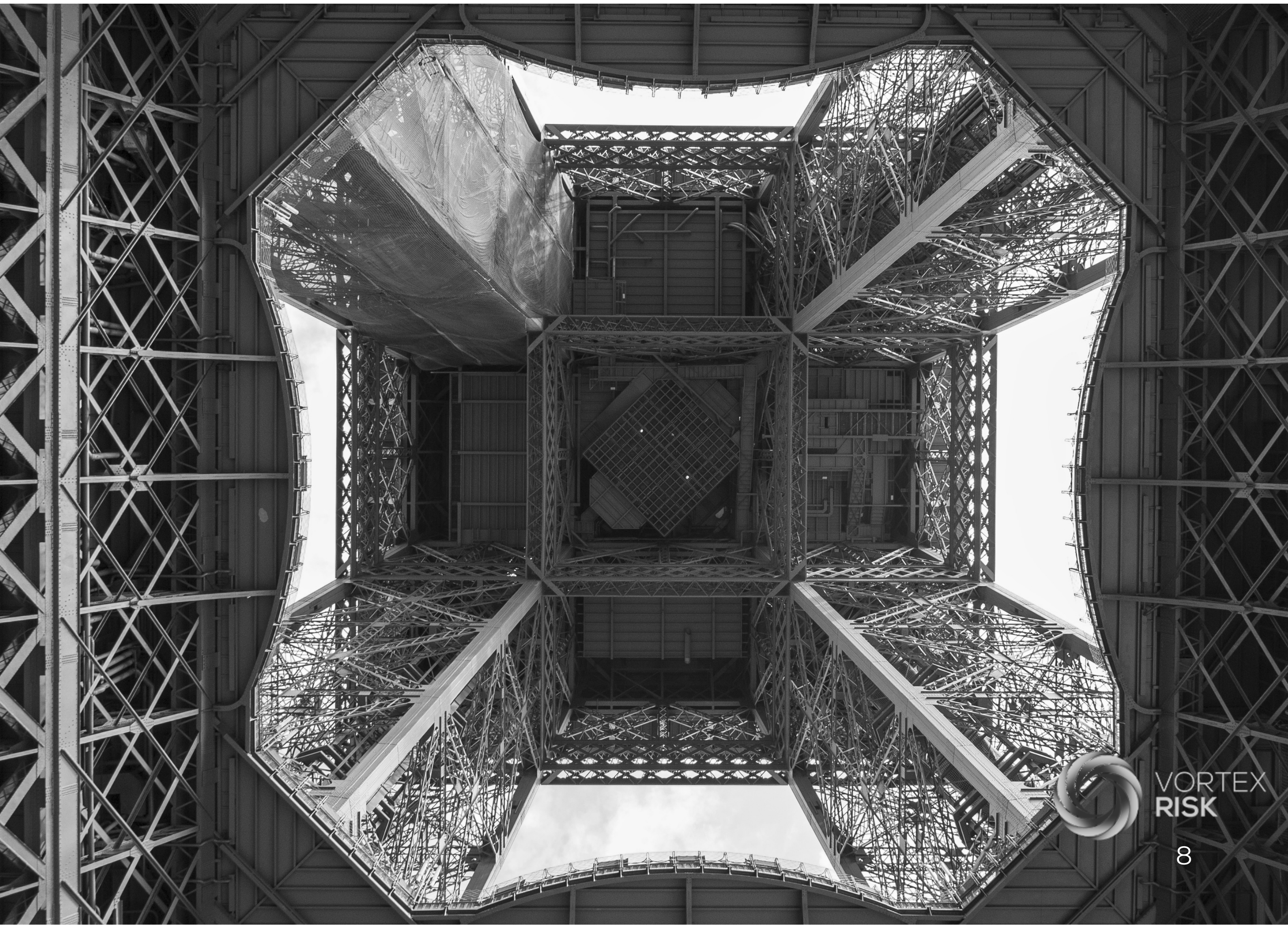
Banks can only effectively assess customers and their transactions against those risk indicators where they have the data to do so; namely in the trade documentation accompanying every trade finance product transaction.

Guided by these limitations, the Wolfsberg Group[2] (an association of 12 global banks which aims to develop frameworks and principles for the management of financial crime risks) recommends that banks should highly scrutinise trade finance products against the FATF's risk indicators and apply adequate TBML policies, procedures, and controls to deter potential criminality.

Other banking products used for trade transactions, where the data is not as robust or easily verifiable, are advised to follow banks' standard transaction monitoring, customer due diligence, and sanctions screening procedures.

[2]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

“Banks will always feel that they not only have to put in place the sorts of risk-based approach that Wolfsberg and JMLSG and FATF and ICC will have pronounced on them, but they also have to be seen to be doing it well…even though it doesn't deliver huge outcomes”.



What are Banks' Risk-Averse Controls on Trade Finance?

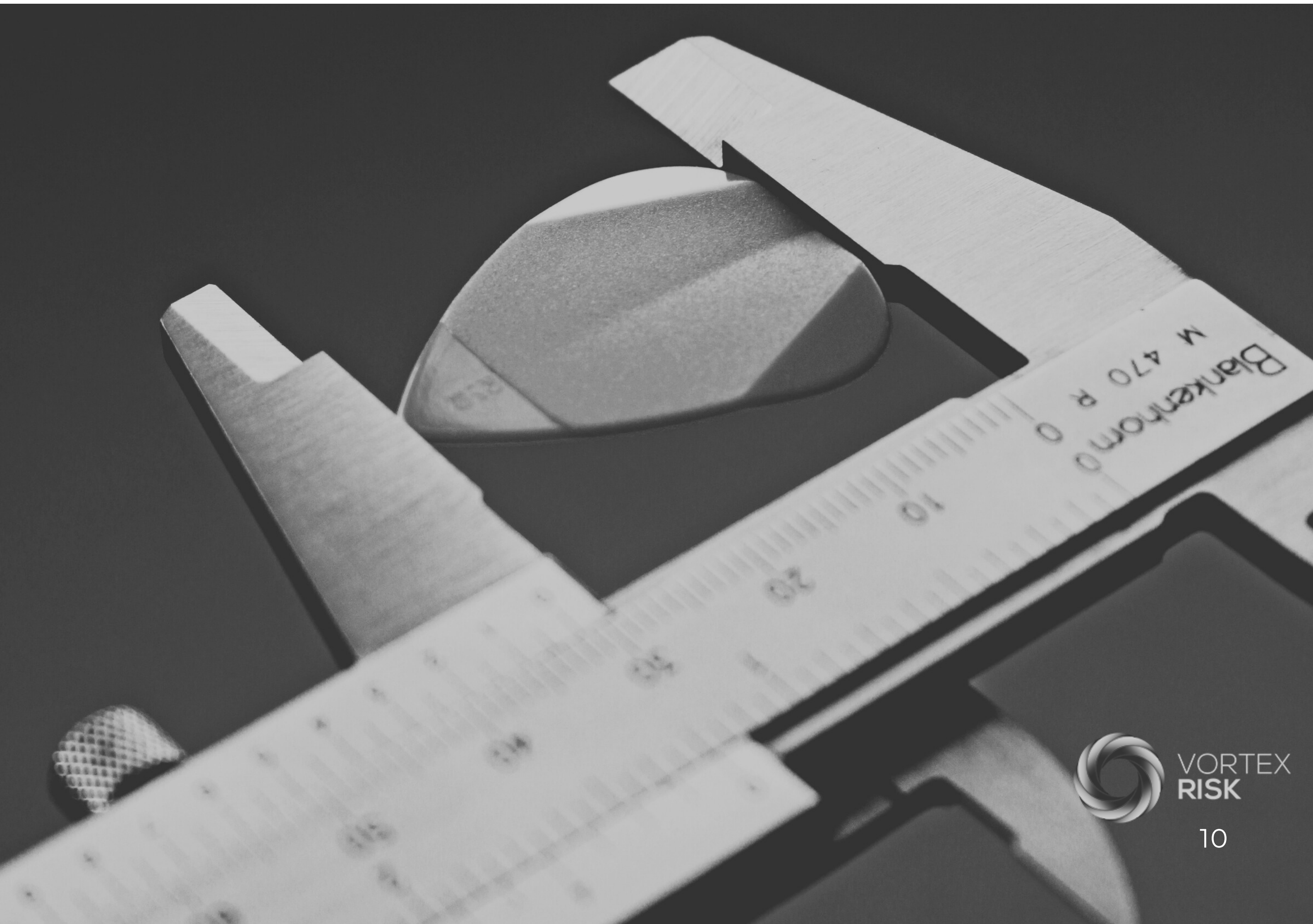
In response to Wolfsberg's recommendations, banks' trade finance controls typically include very strict customer selection criteria and due diligence processes. Most applicants are rejected due to insufficient documentation, the credit risk they pose, or expensive compliance checks. For example, 40% of small and medium enterprises (SMEs) trading internationally face global de-risking due to expensive regulatory demands.[3]

Those accepted, mostly big commodity traders already under much global scrutiny by various authorities, undergo periodic or event-driven reviews so that banks can reassess their risk rating. Further, dedicated relationship managers are tasked with thoroughly understanding their customers' business activities and reporting any suspicious behaviours. Enhanced due diligence checks commence should a transaction and/or a customer trigger high-risk TBML indicators.

Furthermore, each trade finance transaction is reviewed by at least two independent trade operators before being sent to a compliance department for further checks should a suspicion be found. Banks with large transactional volumes also invest in compliance technologies to automate the red flags and/or suspicious alerts review process, as it would be difficult for humans to disposition manually.

[3] Asia Development bank (2023). 2023 Trade Finance Gaps, Growth, and Jobs Survey. https://www.adb.org/sites/default/files/publication/906596/adb-brief-256-2023-trade-finance-gaps-growth-jobs-survey.pdf

"Ultimately, we don't see that much evidence really that TBML on trade finance is necessarily a preferred or very commonly used money laundering technique, as it is almost being presented".



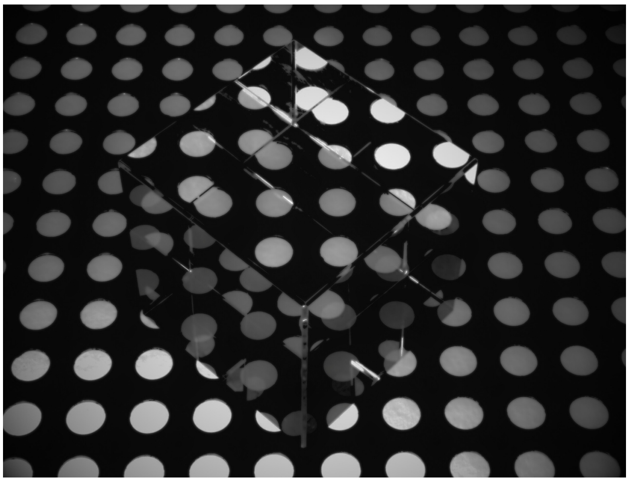
TBML Case Studies Output Rules

Despite banks' TBML experiences not quite aligning with the FATF's TBML risk indicators, these continue to feature in regulatory guidelines.

Recently, the FATF and Egmont Group of FIUs published updated TBML Trends and Developments[4], followed by TBML risk indicators[5] that differ little from the previous versions. The repeating knowledge boils down to how these are created.

One of the critical information sources is the '*numerous case studies from around the FATF's Global Network, [that] explains the ways in which criminals exploit trade transactions to move money, rather than goods*.'[4, p.1]

In a case-based approach, a TBML diagnosis is made based on known signs and patterns. The remedy is then a set of standard trends, typologies, and red flags for all banks to tick and the regulators to check against - therefore supporting the rule-based system.[6]



Unlike the rule-based or case-based system, the risk-based approach does not prescribe a standard TBML remedy but gives banks the freedom to judge independently whether a client's behaviour is 'risky,' if it looks like TBML, and if a suspicious report should be filed.[7]

These RBA principles, however, demand that the regulators stop treating banks as '*ignorant children who have to be taught a lesson*'[7] and trust in their abilities to make sound risk-based decisions. Many regulators, however, are not comfortable with this new approach to supervision.

[4] FATF. (2020). Trade-Based Money Laundering Trends and Developments. https://www.fatf-gafi.org/content/dam/fatf-gafi/reports/Trade-Based-Money-Laundering-Trends-and-Developments.pdf.coredownload.inline.pdf
[5] FATF. (2021). Trade-Based Money Laundering Risk Indicators. https://www.fatf-gafi.org/content/dam/fatf-gafi/reports/Trade-Based-Money-Laundering-Risk-Indicators.pdf.coredownload.inline.pdf
[6] Ross, S. , Hannan, M. (2007). Money laundering regulation and risk-based decision-making. *Journal of Money Laundering Control, 10*(1), 106-115. DOI 10.1108/13685200710721890
[7] Unger, B., Van Waarden, F. (2009). How to Dodge Drowning in Data? Rule- and Risk-Based Anti-Money Laundering Policies Compared. Review of Law and Economics, 5(2), 953-986.DOI: 10.2202/1555-5879.1423

"Maybe this is the experience of a large institution that is heavily regulated, but there often seems to be almost like an assumption by regulators that banks are just trying to comply with the minimum amount they can comply with, that they are regulatory compliant and they can just get about their business."

The Crying Wolf Problem

Although the rule-based framework provides more legal confidence regarding what the regulators and banks should identify as TBML, it has been widely criticised for encouraging formalistic over-reporting of highly useless data.

The risk-based approach, therefore, has been introduced to correct this problem[7]. However, despite many countries claiming to have been using the RBA for some time now, their over-reporting volumes have gone up[7]. This can be explained as the 'crying wolf' factor named after a children's tale about a boy "who cried wolf so often that his cries became meaningless".[8]

'Crying wolf' arises due to the excessively high fines for non-compliance with the regulatory expectations.[8] Banks, in fear of the regulators mistrusting their risk decisions, simply choose to err on the safe side and report transactions that are less suspicious but fit into the prescriptive TBML red flags and risk indicators.[7]

Equally, banks fear that the regulators could interpret declined reporting volumes as indicative of ineffective controls and punish them with large fines.

"There is little motivation to truly uncover TBML as the focus is on identifying suspicion and filing SARs."

"It's a lot easier to fine a bank with a lot of money than it is to capture a criminal."

[7] Unger, B., Van Waarden, F. (2009). How to Dodge Drowning in Data? Rule- and Risk-Based Anti-Money Laundering Policies Compared. Review of Law and Economics, 5(2), 953-986.DOI: 10.2202/1555-5879.1423
[8] Takáts, E. (2007). A Theory of "Crying Wolf": The Economics of Money Laundering Enforcement. International Monetary Fund. https://www.imf.org/external/pubs/ft/wp/2007/wp0781.pdf

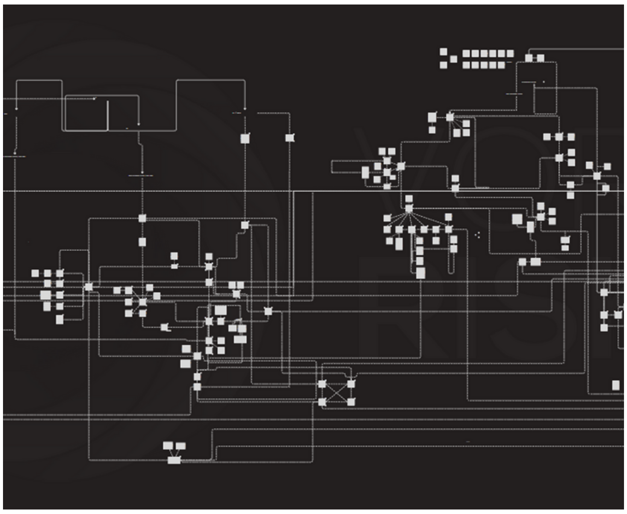
“The ideal solution would empower banks with the knowledge to adopt TBML preventive measures commensurate with how they experience the problem. In essence, a solution providing banks with a methodology on how to move from costly rule-based compliance to an effective risk-based approach.”

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.

RAMP finally closes the TBML knowledge gap with the tacit knowledge of industry practitioners, theoretical and empirical research, and our own money laundering experiences spanning over 30 years.



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.

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

Dr. Mariola Marzouk
Vortex Risk Co-Founder

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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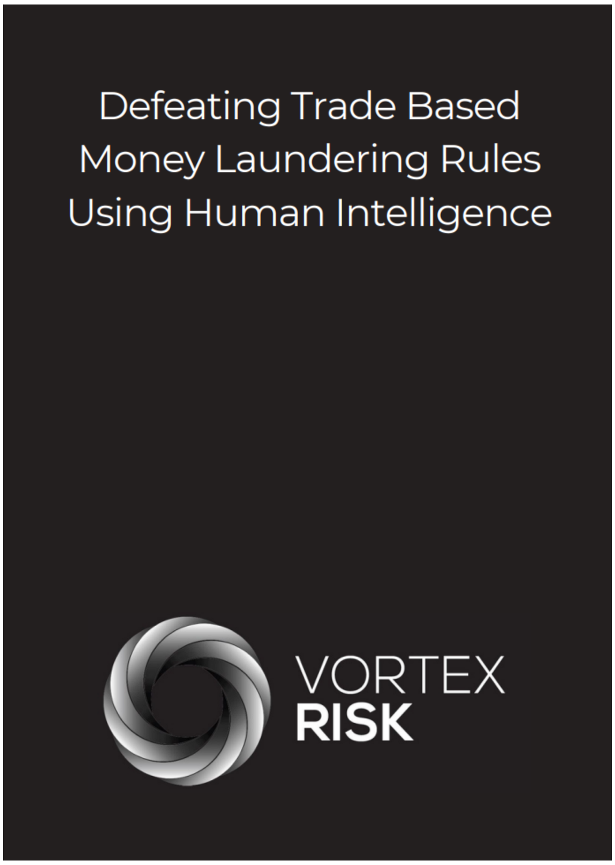
Further Reading on Vortex Risk Website



Defeating Trade Based Money Laundering Rules Using Human Intelligence

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