Preventing Terrorism Financing in Trade Finance – What to look out for

1. Introduction

The continued threat of terrorism in Syria, Iraq, Afghanistan and its increased occurrence in Western Europe has focused law enforcement agencies, regulators and participants in trade finance globally on the potential misuse of trade and trade finance channels for the raising of financing of terrorism threats by outlawed groups.

Global Finance Integrity, the Washington DC based research organisation estimated in their 2014 report on illicit fund movement that the world's poorest countries haemorrhaged some US$6.5 trillion between 2003 and 2012 meaning that for every US$1 of aid given to developing nations around US$10 was leaving those country illicitly. GFI say that of the illicit funds moved globally every year, around 80% is laundered through trade and most for purely criminal purposes. No wonder then that regulators and law enforcement agencies are taking an interest.

Global merchandise trade is a US$18 trillion plus market. Crucially, it is also a market in which hundreds of thousands of individual financial movements both large and small flow through international banks every day. Among those payments will be some illicit funds. Without suffocating international trade entirely however, it is virtually impossible to intercept every illicit payment – event with the most diligent enforcement of regulatory standards. However there are undoubtedly areas, as we suggest below, where the international trade community can do better.

There are a number of similarities between the act of laundering criminal property which accounts for the bulk of illicit payments on one hand and the methodology for financing terrorist activities on the other hand. There are however some key differences between the two. The funding of terrorism is in general more difficult for financial institutions and law enforcement agencies to detect and prevent because:

terrorism financing can and often does encompass any financing of terrorist activity which could involve small amounts to finance a single "lone wolf" terrorist act or the flow of a significant amount of funds financing the infrastructure of major terrorist organisations such as Al Qaeda or ISIS. The difference in terms of funds flow can make it difficult to detect compared to money laundering which tends on the whole to consist of significant individual amounts of funds laundered in one go ; and

1. unlike money laundering, terrorism can be and often is financed by apparent legitimate sources such as charitable donations and it is difficult for those involved in the financial sector to determine at which point those funds cease to be legitimate and are therefore determined to be funds intended for financing terrorism. In the past, organisations such as Sanabel Relief Agency which was registered with the United Kingdom Charity Commission were subsequently found to be fundraising fronts for Al Qaeda and other terrorist organisations.

2. **Money laundering in the Trade Finance Sector**

The legal and regulatory network put in place to prevent and detect money laundering and terrorist financing internationally is now w extensive and covered by more than one source it being international cooperation, local primary legislation, regulation, rules and guidelines. The anti-money laundering regime and the counter terrorism regime go hand in hand and therefore several key elements of the applicable framework for countering money laundering that are currently in place for example in the United Kingdom are the same for countering terrorism financing. The authorities must use ever more sophisticated tools to trap those using the cover of trade transactions to finance criminal or terrorist activity.

Such sophistication is necessary. The techniques used by money laundering criminals and by terrorist organisations are also sophisticated and are often difficult to spot. .

Money launderers use different techniques that evolve and adapt to the regulatory framework and the law enforcement environment in place as well as to the type and the source of criminal property that is being laundered. For trade based money launders and terrorist, either (i) the importer/buyer and exporter/seller of the goods act in concert and are aware that the funds originate from illicit means or (i) only the exporter/seller or the importer/buyer is laundering money and the other is not aware that the funds are illicit; in which case the launderer is acting fraudulently towards to other party.

The current techniques used by trade based money launders that have been identified are the following:

Under Invoicing

A money launderer is under invoicing when the goods are exported at a value which is below the fair market value of the goods.

Over Invoicing

Over invoicing is the opposite of under invoicing where the goods are exported at a value which is above market value of the goods so that the exporter/seller will have an excess value upon payment from the importer/buyer.[1]

Multiple Invoicing

This is the case where more than one invoice is issued for the same goods whereby the exporter/seller can justify the receipt of multiple payments from the importer/buyer for the same shipment.

Over Shipment

In this case, the seller/exporter delivers more goods than the quantity or quality (or both) of the goods provided in the invoice. Here the value of the goods is misrepresented in the shipping documents.

Under Shipment/Short Shipping")

This is the opposite to over shipment where the seller/exporter delivers less goods than the than the quantity or quality (or both) of the goods provided in the invoice, allowing the exporter/seller to receive excess funds from the importer/buyer.

Phantom Shipments

This is the extreme case of under shipment where no goods are shipped at all and all shipping documentation is falsified.

False or Misleading Description of Traded Goods

This technique involves falsifying information on the transaction documents or in relation to the type or the source of the goods traded so as to mislead the other parties in avoiding any suspicion on their behalf (i.e. dual purpose goods)

Use of front companies and shell companies

This technique consists of masking illicit funds behind businesses that have legitimate business activities generating legitimate business profits often established in tax havens with tough banking secrecy laws.

Use of funnel accounts

In this case, the money launderer deposits the funds in one geographical area (often in amounts below the cash reporting threshold) which are then withdrawn in a different geographical area.

Use of Barter Transactions

These transactions involve the exchange of one good for another. An example of this is the diamond market which we discuss below.

Lightly Regulated Countries and Free Trade Zones

These countries and zones are attractive to money launderers as it is easy to set up legal entities, to avoid or bypass custom controls and to undertake operations in which goods are transformed or used to produce other goods (i.e. dual use goods).

Terrorism Financing through Trade

Recent examples of terrorism financing through trade which have emerged include:

Tobacco Smuggling

In 2002, a claim was filed by the European Community against an American tobacco company alleging money laundering activities surrounding cigarette smuggling. It was suspected that the proceeds from the smuggling of cigarettes from Turkey, through the Northern border of Iraq, and into two PKK controlled areas of Iraq (allegedly violating trade embargoes in Iraq). Were used to fund terrorist activities of the PKK and other terrorist organisations operating in Northern Iraq.

In 2004, 10 people were arrested for smuggling more than USD 2 million in contraband cigarettes from Virginia to New York. One subject was arrested in Detroit and found with hundreds of thousands of dollars in wire transfer receipts showing payments to people associated with Hezbollah.

Sugar Trade

Allegations have been widely published to the effect that sugar exported from Somalia to Kenya illegally is funding the terrorist group Al-Shabaab.

The production and refining of Oil

ISIS is believed to control some sixty per cent. of Syria' oil fields and have established export routes, including allegedly across the Turkish border, to raise finance for their terrorist activities.

The Diamond Trade

The Financial Action Task Force (FATF) and the Egmont Group of Financial Intelligence Unites have recently produced a report on Money Laundering and Terrorist Financing through Trade in Diamonds[2]. In this report, it points out that the diamond market has vulnerabilities that can be used and exploited by money launders and persons wishing to finance terrorism. Examples of such vulnerabilities are:

- the global nature of the trade;
- diamonds can also as currency;
- it is difficult to produce a price benchmark;
- it is a market that requires specialist knowledge where law enforcement authorities and financial institutions do not necessarily have the requisite knowledge or level of awareness of the market; and

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- the specificities of the product (small in size and in weight so easily transportable and of high worth where one stone can reach more than USD 20 million).

This report concludes that "d*iamonds could therefore be used to finance terrorism in a scenario where a donor or financier purchases diamonds legitimately, using lawfully derived funds, and then transfers the diamonds to a terrorist or terrorist organisation who use the diamonds in exchange for equipment or cash intending to finance terrorist activiti*es."

3. What Can Be Done to Prevent Terrorism Financing in Trade Finance

In order to be proactive and stay ahead of the overflow of regulatory reform and to mitigate the risks associated with money laundering and terrorist financing in trade finance, financial institutions and trade organisations need to, amongst other things, design and implement risk based monitoring and customer due diligence procedures within their policies and training.

The main obligations and guidance widely accepted as being specific to the trade finance sector are as follows[i]:

The Ability to Assess the Risk

Risk based approach starting point is that the customer is not a money launderer and that criteria to be established in the firm's policy should indicate whether a customer presents a higher risk. Higher risk must be escalated to senior management.

Customer Due Diligence

Due diligence is to be undertaken on the customer who is the instructing party for the purpose of the transaction. It is often the case that for trade finance transactions, the customer is already a customer of the bank where due diligence has already been carried out and where the bank is to assess whether further due diligence is required. Best practice for due diligence on the other parties should be carried out- the extent of such due diligence should be contained in the firm's written policy but should be more or less extensive depending on which capacity the financial institution is acting in, to the extent of information the financial institution has access to and if enhanced customer due diligence is required (in correlation to the risk involved).

(i) Different Capacities of the Financial Institution in a Trade Finance Transaction

The instructing party, on which customer due diligence is to be carried out by firms, will depend on the role of the firm in question in the transaction and the instruments that the bank is providing[ii]:

- Import (Outward) LC – instructing party for the issuing bank is the applicant;

- Export (Inward) Letters of Credit – the instructing party for the advising/confirming bank is the issuing bank.;

- Outward Collections – the instructing party is the customer/applicant;

- Inward Collections – the instructing party is the customer/applicant; and
- Bonds/Guarantees – the instructing party is either the customer, correspondent bank of other third party.

(ii) Forfaiting Transactions

Forfaiting is a method of trade finance that allows the exporter to transfer account receivables at a discount to financial institutions in consideration for cash on a "without recourse" basis. In this case, the instructing party will normally be the exporter on whom due diligence should be carried out. The firm should also carry out due diligence on the other parties to the transactions, such as the importer and the transaction documents to ensure the validity of the transaction.

(iii) Enhanced Due Diligence

When the transaction presents a higher risk based on the firm's risk assessment of the transaction (i.e. types of customers, countries in which the trade is involved, type of goods, etc.), customer due diligence should be undertaken as per above with additional checks that will enable the bank to fully understand the commercial aspects of the transaction and to obtain sufficient comfort on the legitimacy of the transaction. Examples of the additional checks are as follows[3]:

- Enquiries into the ownership of the other parties of the transaction;
- Obtaining information from the instructing party on the frequency of trade and as to the quality of the business relationship between the parties;
- Checking the ICC International Maritime Bureau for warning notices; and
- Referring the transaction to external agencies such as the ICC Commercial Crime Services.

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Monitoring

Financial institutions are under an obligation to report suspicious transactions. In their general monitoring, financial institutions usually use the following information to flag suspicious transactions[4]:

- Payment values;
- Volume of payments;
- Countries of payment;

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- Originator and beneficiary;
- Patterns based on the country or entity involved; and
- Volume of shipments.

The depth and frequency of the monitoring depends on the risk analysis of the business/transaction/parties involved.

In any event, structured controls and procedures for monitoring purposes should be included in firms' policies.

2. Training of Staff

Firms must hire staff with a high level of understanding of the trade finance sector, including export licence regimes and authorisations of trading. The staff need to be trained on a regular basis on how trade finance transactions can be used by money launders and how to understand and manage the risk. "Red Flags" which should be spotted include:

- Significant discrepancies between the description of the commodity on the bill of lading and the invoice;
- Significant discrepancies between the description of the goods on the bill of lading (or invoice) and the actual goods shipped; and
- Inconsistency between the size of the shipment with the scale of the exporter's or importer's regular business activities.

Summary

The global market has presented great opportunities to compete in international trade and has helped raise the living standards of the poorer trading nations. However it also presents an opportunity to those who would abuse the system for criminal and terrorist motives. As an industry we must be vigilant. The laws and rules vary somewhat from nation to nation but due diligence and enhanced sue diligence assumes an ability on the part of the institution to deploy people with the requisite skills and experience to win the battle. Regulators are suspicious because they don't understand the business. We have some educating to do and also some acknowledgement of areas where we must improve as an industry if the movement of illicit funds on the scale mentioned above is to be checked.

Robert Parson, Partner, Imogen Holmgren, Trainee Solicitor, Reed Smith

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