



Financial crime risk controls

Dual-use goods and proliferation financing



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Introduction and background

Dual-use goods (DUG), specifically defined as items having commercial and military or proliferation applications, are subject to a variety of export restrictions and controls set by national and/or international agencies. These can sometimes be in the form of sanctions but usually take the shape of licencing requirements placed upon corporates.

The concept of DUG intersects several areas of financial crime compliance within the financial services industry, including proliferation financing, export controls and trade sanctions. Financial institutions (FI) should remain cognisant of these convergences, as regulatory expectations may differ and bring products outside of trade finance and trade services into scope. For example, under UK and EU sanctions legislation, the definition of the provision of “financial services” and “financial assistance” in relation to the movement of DUG, is broad, requiring a wider assessment of the risks and controls.

FI are aware of the requirement to have appropriate risk-based controls to identify transactions which involve such goods, while regulators continue to highlight the need for FI to have in place appropriate controls and identification methods, for example, as noted by the UK Prudential Regulation Authority and Financial Conduct Authority ‘Dear CEO Letter’ on Trade Finance Activity, published in September 2021. In certain jurisdictions, regulators may specifically require FI to undertake screening of specified lists of goods, as seen in the UAE.

The UK authorities’ letter draws out the need to sufficiently focus on the identification and assessment of financial crime risk factors, such as the risk of DUG or the potential for fraud, and consequently to perform a sufficient level of due diligence, such as additional pricing checks or the use of tools like vessel tracking and independent document verification.

Objectives

This paper provides an updated discussion on a) the challenges associated with the implementation of controls relating to the identification of DUG risk in trade finance transactions; b) the prevalent financial industry-wide approach to DUG; and c) the feasibility of potential controls for the effective identification of DUG.

Finally, it aims to summarise best practices and recommendations for FI engaged in trade finance, recognising that a variety of approaches hold validity based on the individual circumstances of respective institutions.

Similarly, it observes that no single solution or approach will be appropriate for all, while further recognising that blunt goods name screening approaches are often of limited effectiveness in isolation.

Scope

While the subject of DUG is the core focus, the paper also references wider proliferation financing risk. Export controls are recognised as an emerging area of heightened risk management and regulatory focus, with DUG consistently retaining prime importance. The paper aims to reference and draw these parallels out, and to note challenges and respective roles, responsibilities and capabilities of FI, exporters, customs, etc.

Regulatory requirements and guidance

Available regulatory guidance suggests that screening trade transactions to identify DUG is an appropriate measure which merits consideration by FI while outlining associated limitations which prove this equally difficult to accomplish.

Part II Sectoral Guidance (amended in July 2022): The guidance by the Joint Money Laundering Steering Group (2022) outlines that DUG destined for proliferation use are difficult to identify, even when detailed information on a particular good is available. Regardless of the amount of information provided for a particular good, highly specialised knowledge and experience is often needed to determine if a good may be used for proliferation. Dual-use items can be described in common terms with many uses – such as “pumps” – or in very specific terms with more specific proliferation uses – such as “metals with certain characteristics”. Further, many goods are only regarded as dual use if they meet very precise performance specifications.

Policy Statement 470/1285: This paper by ICC (2019) concludes that screening goods against a list of DUG at an individual transactional level has proved ineffective. However, by undertaking targeted customer analysis across key corridors combined with customer data outside of the trade finance department, FI could work towards mitigating proliferation financing. Information sharing between the private and public sectors is imperative for any of these solutions to work and to build a stronger and collaborative regime to counter proliferation financing.

Guidance on Countering Proliferation Financing: This paper by FATF (2018) reinforces this perspective with its guidance to competent authorities around the effective sharing of information, i.e., a well-coordinated inter-agency mechanism, with participation of all relevant operational agencies. This mechanism facilitates the investigation of proliferation financing activities and helps detect sanctions evasion through more effective sharing of information among public authorities, the Financial Intelligence Unit and the private sector.

Trade Finance Principles: The guidance paper by the Wolfsberg Group, ICC and BAFT (2019) identifies the challenges of identifying DUG. It states that while FI may be able to identify obvious DUG, corporates, customers, customs and export licensing agencies are better at detecting them. The principles accept that a FI, as part of their risk-based approach, should provide guidance and regular training to staff to raise awareness of DUG and the common types of goods which have a dual use. They emphasise that staff should attempt to identify DUG in transactions wherever possible. The principles go even further and outline limitations relative to the technical nature of identifying DUG. Without the necessary technical qualifications and knowledge across a wide range of products and goods, it is almost impossible for a FI to understand the varying applications of DUG. It would be impracticable for FI to employ departments of specialists for this purpose as in doing so they would need to replicate comprehensive scientific research facilities.

Guidance on Proliferation Financing Risk Assessment and Mitigation: The guidance paper by FATF (2021) defines proliferation financing as both dual-use technologies and DUG for non-legitimate purposes. The guidance paper encapsulates risk indicators (RI) drawn out at the customer and account/transaction activity levels. Relevant RI for DUG at the customer level relate to customers not appearing to have the necessary technical background for trading a particular type of goods or goods which are not aligned with the nature of their business. Secondly, they relate to

customers affiliated with a university or research institution and involved in the trading of DUG or goods subject to export controls. Similarly, and with key attention to applicable export controls, account/transaction activity FI relate to

- a. Account holders who conduct transactions that involve items controlled under dual-use or export control regimes, or
- b. Account holders who have previously violated requirements under dual-use or export control regimes; and
- c. Customers' request letter of credit for trade transaction for shipment of DUG or goods subject to export controls, prior to account approval.

Challenges associated with the identification of DUG

Nature of descriptions provided by governments/regulatory bodies are difficult to interpret

Most descriptions provided by strategic control lists prescribed by governments are technically detailed and inherently difficult to practically apply in comparison to standard goods descriptions available in transaction documentation submitted to FI. As an example, a strategic classification such as 'Product from the reaction of Methylphosphonic acid and 1,3,5-Triazine-2,4,6-triamine' would be impossible to detect unless broken down into individual components which may very well read differently and have a perfectly legitimate use in line with a customer's normal course of business (the understanding of which is always the key control point).

Technical nature of goods and challenges for non-expert processing staff

In reference to the above example, without the necessary technical qualifications and knowledge across a wide range of products and goods, the ability for a FI to understand the varying applications of DUG will be virtually impossible. This viewpoint is reflected in the Wolfsberg Group, ICC and BAFT Trade Finance Principles (2019) which concludes that it would be impracticable for FI to employ departments of specialists for this purpose as in doing so they would need to replicate comprehensive scientific research facilities.

Lack of standardisation and ability to use lists in automated screening

There is no standard universally applicable list of DUG, and those currently available relate to the export control lists of various countries. A basic objective of export control lists is to outline the licensing requirements which are applicable to exporters of DUG. While these export control lists vary at a country level, the fundamental need to adhere to these lists remains enforceable between the respective customs authorities and the exporters, i.e., a formal need to comply with extant export control regulations. From a use-case perspective, these lists are extremely complex and detailed for any productive/effective comparison with the goods descriptions available to trade transaction documents/data available to FI. If taking the UK as an example, the UK Strategic Export Control Lists specifies dual-use items as one of five types of controlled goods. Dual-use items in turn are broken down into nine broad categories, each of which are further divided into five separate sub-categories.

False positive rates

Attempts at screening for DUG across FI have highlighted that the reasons for transaction rejection are often unrelated to whether the transaction was originally referred due to the involved goods having any potential dual use. Given that all processed trade transactions would typically attract screening against applicable lists – with goods descriptions available to FI significantly deviating from the actual goods attracting licensing requirements – there will inevitably be an excessive count of false positives. This requires adjudication and is not aligned with any intended use of such lists. For example, the goods ‘sensor’ returns no less than 64 matches when screened against the UK Strategic Export Control Lists with one of the matches relating to ‘Survey equipment designed to measure seabed topography at a range exceeding 200m from the acoustic sensor’.

Incomplete goods descriptions

Trade transaction documentation submitted to FI are representative of the documentation exchanged between buyer and seller to complete a purchase/sale. As such, any information relating to the underlying goods would be as agreed between the transacting parties and this, in turn, may be a detailed goods description including a model/item number, quality standard, basic as well as advanced features and other technical aspects (as might be required for a pharmaceutical active ingredient, a luxury item, or a household appliance) or otherwise quite literally be a generic description (such as ‘furniture’). The absence of detail or, at times, too much detail makes complex analytics or for that matter simple matching logic very difficult to productively achieve.

Deliberate obfuscation

As can be reasonably expected, a bad actor would exercise care to avoid detection by the any potential threat mitigation control employed by FIs in this space. Given that it can be comfortably deduced that DUGs are controlled, any legitimate trade in such items would be subject to licensing with appropriate applications/approvals sought from relevant authorities by exporters.

Approaches to DUG screening

Manual review, list-based screening and escalation by processing staff

a) Manual review

Industry practice continues to rest with the adoption of a risk-based approach (RBA) involving training and awareness around DUG to equip processing staff with the knowledge to identify DUG and escalate where any reasonable commercial application does not appear to align with the customer’s nature of business.

b) Goods list based screening

Efforts by FI to screen goods descriptions available in trade transaction documents/data against comprehensive lists of DUG published by the Hong Kong Monetary Authority and Monetary Authority of Singapore have been of limited efficacy due to these lists not being effective as an in-flight control on account of having produced an unmanageable number of

false positives, are not configured for ease of screening, items in the list not being consistent with items listed in trade transaction documents, impacting the client experience due to the unwarranted time spent in the resolution of false positives and cost of implementation/management.

c) Name screening

Screening against entity lists are designed to identify parties that are at greater risk of shipping goods to Weapons of Mass Destruction (WMD) programmes. Most likely suspecting to support terrorism or other activities contrary to national interest or foreign policy interests, i.e., the Export Administration Regulations (EAR). The U.S. Department of Commerce's Bureau of Industry and Security administers U.S. laws, regulations and policies governing the export and reexport of commodities, software, and technology (collectively "items") falling under the jurisdiction of the EAR.

d) Customer due diligence (CDD)

Robust CDD procedures will identify customers that import or exports goods. As part of this process, enhanced due diligence may be undertaken in cases where the countries, products or customers involved are deemed to be high risk or where the goods they trade might be of a dual use nature. Depending on the risk posed by the customer, enhanced monitoring may be required.

Automated detection through emerging technology

a) Certain technologies are being developed by third party vendors for use by FI. These technologies are positioned as potential solutions to the challenge in identifying not only DUG and broader trade-based financial crimes (TBFC) concerns. The significant cost associated with the implementation and use of these technologies makes it a challenge for smaller FI to adopt these solutions. At present, technological solutions remain applicable at the post transactional stage unless FI were to create a bridge between live operating transaction platforms and third-party solutions or were otherwise able to develop this technology in-house. A typical technology solution incorporates

- a. automation relative to the extraction of goods description from documents;
- b. standardisation through conversion to universally applicable goods classification (HS codes);
- c. screening against regulatory prescribed lists of dual use goods (where available);
- d. market price analytics;
- e. validation against maritime intelligence;
- f. and comparison across trade data available as subscription only services by aggregators; etc.

b) Automated risk detection capabilities use social analytics and big data techniques to map known risk typologies against broad datasets which encompass customer account/transaction activity, CDD/KYC information, counterparty data, corporate intelligence, and maritime intelligence. In doing so, they can potentially serve to identify TBFC with unusual payment flows and/or shipping corridors which could trigger targeted reviews aimed at detecting proliferation financing.

- c) Automation of risk detection capabilities at the post-transaction stage would serve to isolate specific higher risk cases requiring in-depth review, i.e., the generation of alerts/events which are escalated to specialist teams created to ratify unusual activity to isolate instances which merit Suspicious Activity Reports (SAR) filing. Similarly, challenges exist to enable the industry to evolve sufficiently to use technology as a solution. Challenges are, for example, the standardisation of goods through a data feed rather than physical paper invoices (data input standards/limitations); the probability that goods descriptions available to FI may or may not factually represent the complete goods description; and the absence of HS codes in transaction documentation.

Recommendations and best practices

Considering the challenges in effectively identifying DUG, there will always be a need for training and raising awareness among relevant employees to build and maintain knowledge of the risk associated with DUG and proliferation financing.

Where deemed appropriate, enhanced due diligence measures should be employed to manage higher risk customers through the application of targeted CDD based controls focused on the identification of higher risk business types involving trade in DUG.

Additionally, consideration may also be given to adopting screening mechanisms which trigger against higher risk entity lists with greater exposure to proliferation financing rather than against any extensive list of goods including DUG.

Conclusions

The expectation of FI engaged in trade finance activities to identify clients or their activity which might indicate the movement of DUG and proliferation financing presents challenges. Along with a robust CDD process, the practice of developing and maintaining risk awareness around DUG and proliferation financing should be reinforced with targeted screening against entity lists, where possible; therefore, the more effective screening approaches are at the customer/counterparty level rather than against any list of goods taken in isolation. The primary responsibility of controlling any trade in DUG is that of governmental agencies with the onus on the exporter/importer needing to adhere to relevant regulation by obtaining the required licenses.

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