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Traditional trade finance instruments a high risk? A critical view on current international initiatives and regulatory measures to curb financial crime

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Abstract

This paper examines critically the claim or perception that traditional trade finance instruments pose a particularly high risk in terms of financial crime such as money laundering, terrorism finance, or sanctions violations. The fundamentals of documentary collections and letters of credit are briefly explained so that their role in international trade and trade finance can be appreciated. Further, the paper introduces, concisely, some important types of financial crime, and then refers to governmental and international organisations and their recent initiatives to address the threat of financial crime with regard to international trade and banking. The paper assesses the effectiveness and usefulness of these attempts to curb the misuse of the established trade finance system. Finally, the paper highlights some of the negative effects and consequences that increased legislative and regulatory activities have had in this context, particularly on legal certainty, the increased costs for banks and international traders due to compliance matters, the subsequent industry response of de-risking (such as the refusal of finance requests and the termination of customer or correspondent banking relationships), and, eventually, the worrisome trend towards clean payment (advance payment or open account) transactions.

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1 Traditional trade finance instruments: Transactions that pose high risks *per se*?

In international commerce, traditional trade finance instruments such as documentary collections and commercial letters of credit play an important role for both sellers and purchasers of goods and services, but also for the global commercial exchange in general. During the past several years, however, the perception has arisen and claims have been made that these documentary trade finance products carry an increased and disproportionate risk of involvement and facilitation of financial crime. For example, the Financial Transactions and Reports Analysis Centre of Canada, led by Canada's

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Department of Finance, recently published a guidance document[1] aimed at countering money laundering and terrorism financing, in which the use of letters of credit is listed, generally, as a "high-risk [indicator]". Similarly, in a guidebook for bank supervisors the World Bank described several banking services to "pose higher risks", among them "[i]nternational trade finance and letters of credit".[2] Moreover, in surveying the international banking and trade sector, representatives from major international banks and other organisations noted in 2017 that "[t]here is a perception that Trade Finance is a 'higher risk' area of business from a financial crime perspective".[3] Similar remarks and notions are discernible at conferences, workshops or public meetings within the banking and trade sector, and other relevant publications.

Such claims that discredit traditional trade products motivated outspoken trade finance experts like Sindberg to write, mockingly, of a "high risk ghost in trade finance"[4] and voice the opinion that "regulators, auditors, compliance officers etc […] have constantly labelled Trade Finance as a High Risk area – and that without any kind of evidence to that effect".[5]

2 Fundamentals of documentary collections and commercial letters of credit

International trade transactions usually need finance and other support (transactional, technical, or otherwise) by banks in facilitating payment. However, if so-called "clean payment" is agreed upon by the parties, that is advance payment or open account terms (either payment in advance of dispatch or payment after goods have been received),[6] the parties may only need limited assistance, *ie* wiring the money at the appropriate time and to the specified bank account. In such instances, banks engaged with the money transfer will have limited information and data regarding the underlying transaction. However, if the parties opt for documentary collection or a letter of credit to support their trade transaction, the involvement of banks will focus on documentary aspects and be more substantial. For purposes of this paper, only a concise introduction to documentary collections and letters of credits is provided, as

1 FINTRAC *Risk-Based Approach Guide* (June 2017).

2 Chatain, McDowell, Mousset, Schott and Van der Does de Willebois *Preventing Money Laundering and Terrorist Financing – A Practical Guide for Bank Supervisors* (2009) 223 (alteration by me).

3 The Wolfsberg Group, ICC and BAFT *Trade Finance Principles* (2017) 6 par 1.3 (alteration by me).

4 Sindberg "The high risk ghost in trade finance" www.lcviews.com/index.php?page_id=600 (02-07-2018).

5 Sindberg "Combating trade based money laundering: Rethinking the approach" www.lcviews.com/index.php?page_id=599 (02-07-2018) (omission by me).

6 Aside from the receipt of the actual goods, this could also mean that *documents* relating to the goods, especially transport and insurance documents, have been handed over. This, in many instances, confers ownership and (constructive) possession and therefore can be equated to delivery of the goods themselves.

there are excellent and more detailed treatments of the topic available.[7] For ease of reference, documentary collections and letters of credit will be referred to in this this paper collectively as "traditional trade finance products or instruments".

Traditional trade finance instruments utilise the services of banks in the sense that they receive, examine, and forward documents which relate to the purchased goods, and effect or receive payment at the appropriate point in time. The underlying transaction, on the other hand, is of no immediate interest to the bank. The most relevant documents are transport, storage, and quality/quantity documents (*eg*, bills of lading, warehouse receipts, certificates of quality or quantity relating to facts such as origin, purity, grade, class, amount and weight), insurance documents (cover notes or policies), and documents originating from the seller (packing notes, commercial invoices, or other assurances as agreed upon). If the documents tendered by the beneficiary (*ie*, the seller) comply with the stipulations in the letter of credit, the bank will honour its undertaking – in most cases, that is, make immediate payment.[8] In a documentary collection in its most simple form, the role of the bank is somewhat reversed in the sense that the bank itself offers documents with which it has been entrusted by the seller, to the buyer, and releases them upon payment[9] of the contract price. The documents required in a documentary collection are often similar to the documents called for in a letter of credit.

As indicated above, documentary collections and letters of credit are based on the fundamental notion that a bank will not concern itself with the actual underlying trade transaction. A bank will only refer to the documents specified in the application for these trade products, and will only examine these documents, *ie* check whether the documents are appropriately worded and seem to comply on their face. The actual underlying trade transaction, on the other hand, is largely irrelevant for the facilitating bank. This notion is evident in several ways: international practice rules specifically tailored to govern documentary collections (*eg*, the *Uniform Rules for Collections* (*URC 522*))[10] or commercial letters of credit (*eg*, the *Uniform Customs and Practice for*

7 See, *eg*, Hugo "Payment in and financing of international sale transactions" in Sharrock (ed) *The Law of Banking and Payment in South Africa* (2016) 394 399 *et seq* (for documentary collections) and 403 *et seq* (for commercial letters of credit); DiMatteo *International Contracting* (2016) 126 *et seq* (for documentary collections) and 138 *et seq* (for commercial letters of credit); Ehrlich and Haas *Zahlung und Zahlungssicherung im Außenhandel* (2010) 317 *et seq* (for documentary collections) and 37 *et seq* (for commercial letters of credit).

8 Letters of credit can also be drafted so that the bank's obligation is not to make payment directly but, for example, to accept a draft (and pay it upon maturity of the instrument) or to incur a deferred payment obligation (and pay at the due date).

9 Documentary collections can be designed differently, so that documents will not only be released against payment (so-called D/P collection) but against acceptance of a draft (so-called D/A collection).

10 ICC Publication 522. Aa 10 (b) ("Documents vs Goods/Services/Performances") and 12 (a) ("Disclaimer on Documents Received") state respectively that "[b]anks have no obligation to take any action in respect to the goods to which a documentary collection relates" and that they "must determine that the documents received appear to be as listed" – otherwise, as expressly so stipulated, "[b]anks have no further obligation in this respect".

Documentary Credits (*UCP 600*))[11] make it plain that the banks' involvement in the transaction is limited, principally and practically, to the examination and handling of documents (and payment based on the result of these examinations). The same holds true for the (few) instances in which countries have enacted domestic provisions or law, for instance the People's Republic of China[12] or the United States of America,[13] and, of course, international case law,[14] which confirm that the role of banks in documentary collections and letters of credit is restricted to the examination and the exchange of documents.

Importantly, the pricing policies of banks and other financial institutions that are involved in the issuance and facilitation of traditional trade finance products, clearly reflect the above expectation. It is the expectation that the involvement in the trade transaction is limited to the checking of documents, without investigating the underlying transactions to which these documents may relate. Typically, banks neither have the expertise nor sufficient interest to go "beyond the documents". Their mandate is restricted to the examination of documents, the forwarding of such documents, and the facilitation of payment in appropriate situations based on these documents. Therefore, the charges banks collect from customers and other parties involved in a trade finance transaction are relatively low. If banks were expected to delve into the underlying transaction, analyse the goods shipped and the quality thereof, and so forth, the charges would be considerably higher. Accordingly, it must be appreciated that banks involved in documentary collections and documentary credits are doing more than just wiring money from one account to another – yet they are still not concerned, and should not be, with the underlying transaction itself, but only with the documents relating to it.

In the facilitation of international trade and payment, local banks rely on so-called correspondent banks with which they have correspondent banking relationships. Through these intermediaries the local banks can offer advice, assistance, and services to parties located abroad, and in regions, areas or

[11] ICC Publication 600. Aa 4 (a) ("Credits v Contracts") and 5 ("Documents v Goods, Services or Performance") respectively clarify that a commercial letter of credit is "by its nature […] a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract […]", and "[b]anks deal with documents and not with goods, services or performance to which the documents may relate".

[12] The *Rules of the Supreme Court of the People's Republic of China Concerning Several Issues in Hearing Letter of Credit Cases* (2005) refer in a 2 ("Application of International Rules or Practices") to the *UCP* directly, and state in a 5 ("Time for Honour of Letter of Credit Undertaking") that an issuer has to honour its documentary undertaking "if the documents appear on their face in compliance" and that a Chinese "court shall not give effect to a defence based on the underlying transaction".

[13] Likewise, the Uniform Commercial Code (UCC) Revised Article 5 (Letters of Credit) in the United States of America provides in Section 5-108 (a) that "an issuer shall honor a presentation that […] appears on its face strictly to comply with the terms and conditions of the letter of credit".

[14] See, for example, the English case of *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159; or the South African case of *OK Bazaars (1929) Ltd v Standard Bank of South Africa Ltd* [2002] ZASCA 5 (12 March 2002).

jurisdictions in which they themselves do not have a presence (*ie*, do not operate a local branch or subsidiary).[15] This is vitally important for traditional trade products for which, in many cases, banks need to be able to provide services across borders and in multiple jurisdictions. Examples are the exchange or transmission of documents in a documentary collection by the remitting bank to a collecting bank,[16] or the advice or confirmation of a letter of credit by a bank operating in the jurisdiction of the beneficiary.[17] Without a network of trusted correspondents this would be impossible.

Regarding compliance issues in relation to the combatting of financial crime in the context of this paper it is important to note that the utilisation of traditional trade instruments will require the banks to examine documents relating to the underlying transaction. These documents provide banks with transactional oversight and data regarding the names and identities of the parties involved, the goods and respective shipping routes, and other financial arrangements and transactional patterns. Data gathered and documents examined during documentary collections or a letter of credit transaction can then supply information which can be examined for compliance purposes relating to the combatting of financial crime, that is checking it against databases and lists and comparing it with existing customer profiles and previously established and recorded transactional patterns.

On the other hand, as pointed out above, if the trade parties settle for clean payment terms (providing for open account or advance payment), the involvement of banks is limited considerably and they are deprived of almost all transactional data and insight.

3 Fundamentals and important types of financial crime

Financial crime denotes the use of the financial system and financial institutions to facilitate crime. While it is difficult to define the term "financial crime" with precision,[18] it is possible and helpful to list several types of crimes that typically fall within its ambit.[19] For purposes of this paper, sophisticated and refined definitions are not necessary but a short introduction to some of the crimes and offences will suffice.

[15] See Basel Committee on Banking Supervision *Guidelines Sound Management of Risk related to Money Laundering and Financing of Terrorism* (June 2017) 23 Annex 2 par 2.

[16] See Hugo (n 7) 399.

[17] See Hugo (n 7) 405-406.

[18] Gilligan "The problem of, and with, financial crime" 2012 *Northern Ireland Legal Quarterly* 495 500 *et seq*.

[19] BAFT *Guidance for Identifying Potentially Suspicious Activity in Letters of Credit and Documentary Collections* (March 2015) 6; Byrne and Berger *Trade Based Financial Crime Compliance* (2017) 45.

3.1 *Corruption and bribery*

Corruption is "a serious problem in many countries around the world"[20] and "a complex concept that is affected by linguistic usage, ethical perspectives and cultural nuances",[21] and because of this, "anti-corruption conventions have not attempted a general definition of corruption".[22] Nevertheless, scholars have tried to define corruption in general terms and, according to Carr and Stone, these definitions "rotate around economic or other gains made by an individual in a position of power as a result of that individual's role within an organisation or institution".[23] Similarly, bribery could be defined as a person offering, giving or promising to give a financial or other advantage in exchange for the improper performing of a specific function or activity.[24] Scholars have described the concept of financial advantage in this regard as a "relatively straightforward concept".[25] No attempt should be made here to provide a general definition of corruption or bribery; rather one may accept that corruption and bribery, in the present context, denotes the illegal exercise of power by a (state) representative or (public) office bearer to gain material advantages, or the payment for such abusive and illegitimate exercise of power, respectively.

3.2 *Money-laundering activities*

Money laundering refers to the activity of inserting funds that stem from illegal activities (drugs or arms trade, tax evasion, fraud, corruption, bribery, or other crimes) into the regular financial system with the aim of obfuscating the origin of the funds.[26] To hide the fact that the source of the money was a criminal act, money laundering operations typically use seemingly legitimate businesses or transactions so that the existence of money, often cash, can be explained.[27] Once circulating in the regular financial system and thus "laundered", the funds can be used freely, that is spent, transferred, or invested, all within the banking system. Because of the serious implications of money laundering, many domestic and international efforts of combatting financial crime focus, to a significant degree, on money laundering and the prevention thereof. Scholars

[20] Quah *Different Paths to Curbing Corruption* (2013) 1.

[21] Carr and Stone *International Trade Law* (2018) 678. In this regard, see Loughman and Sibery *Bribery and Corruption Navigating the Global Risks* (2012) 269 for what they perceive to be the "most common corruption risks in Africa".

[22] Carr and Stone (n 21) 679.

[23] Carr and Stone (n 21) 679.

[24] See Heimann and Pieth *Confronting Corruption* (2018) 31; Uff *Construction Law* (2017) 20 (with reference to the UK Bribery Act of 2010, section 1).

[25] Lee and Tankel "Bribery" in Wilmot-Smith (ed) *Wilmot-Smith on Construction Contracts* (2014) 493 496 par 19.13.

[26] Ellinger, Lomnicka and Hare *Ellinger's Modern Banking Law* (2011) 92; Zentes, Glaab, Becker and Heemann *AML in der Bankpraxis* (2014) 13 par 16/1; UNCITRAL *Recognizing and Preventing Commercial Fraud* (2013) 6.

[27] BAFT *Combatting Trade Based Money Laundering: Rethinking the Approach* (August 2017) 3.

estimate that in large industrialised countries laundered money amounts to billions annually.[28]

3.3 *Violation of sanctions and terrorism financing*

Violation of sanctions and financing of terrorism are two other main aspects of financial crime that have seen much and far-reaching developments, both on domestic as well as international fronts. In the context of financial crime, sanctions mean formal prohibitions imposed by governments or competent international bodies against dealing with certain persons, commercial entities, regions or countries. Sanctions can relate to all transactions *per se*, or be limited to certain persons and entities, transactions and services, sectors, goods, or threshold amounts.[29] The imposition of economic sanctions will typically have a stifling effect on the respective entities or countries,[30] and the mere rumour of a fresh series of sanctions, or additional measures of economic isolation, that a financially-powerful country (*eg*, the United States of America) or entity (*eg*, the European Union) is allegedly contemplating can have tremendous repercussions for the concerned parties. Merchants and banks are likely to scale down their commercial engagements and contractual obligations, refrain from forging new business deals, or at least factor-in the risk of possible economic sanctions and uncertainty as well as related transactional problems and costs.

The financing of terrorism, a concept that is often widely defined and politically influenced,[31] is also strongly prohibited based on domestic or international statutes, regulations or conventions. Often, the countermeasures

[28] Zentes, Glaab, Becker and Heemann (n 26) 13 par 16/1. Loughman and Sibery (n 21) 3 state, overall, that "[b]ribery and corruption has a very detrimental effect on an economy" (alteration by me), and that "[t]he impact of bribery and corruption can't be understated" (at 4; alteration by me). See also Heimann and Pieth (n 24) 39-40.

[29] Hocke, Sachs and Pelz *Außenwirtschaftsrecht* (2017) 913 par 79; Bertrams *Bank Guarantees in International Trade* (2013) 345-346.

[30] Stalls writes of "powerful impact": see "Economic sanctions" 2003 (Fall Issue) *University of Miami International and Comparative Law Review* 115 118. Commercial and financial transactions with Iran or Iranian entities are still, at least in part, subject to sanctions and restrictions. Therefore, for example, the German trade association VDMA, representing companies from the mechanical and engineering industry, reports that difficult financing conditions and remaining US sanctions prevent the realisation of economic potential of the Iranian economic market; see VDMA Arbeitsgemeinschaft Großanlagenbau *Lagebericht 2017/2018 Beiträge zum Industrieanlagenbau* (2018) 20.

[31] The concept of terrorism and the use of this label in a political context is subjective and can be highly problematic. To use a South African example, one may consider the prominent case of the former president of the Republic of South Africa, the late Nelson Rolihlahla Mandela, whose public portrayal and international appreciation over the past decades was deeply influenced by the current political circumstances. See also the remarks regarding liberation movements and express references to anti-colonial struggles in Weißer "Transnational organised crime and terrorism" in Hauck and Peterke (eds) *International Law and Transnational Organised Crime* (2016) 84 96-97.

directed at money laundering activities are also aimed at terrorism financing.[32] This is explained by scholars who point out that "[t]he ease with which money may be transmitted from jurisdiction to jurisdiction means that money laundering and the financing of terrorism usually involve a number of financial centres. […] It follows that money laundering and the financing of terrorism will only be effectively disrupted if all jurisdictions play their part in the fight against both activities."[33]

Apart from the types of financial crime referred to above, other offences such as serious fraud, export controls violations,[34] anti-boycott violations,[35] tax evasion, and capital and foreign exchange control measures violations[36] can be addressed by laws and regulations aimed at combatting financial crime.

Because many of the mentioned types of financial crime are facilitated across borders, or pose a serious threat on a wider, international level, the responses by governments and law enforcement are also often coordinated and aligned along international standards, or at least strive to be.

Particularly in developing countries the effect of financial crime, especially corruption and bribery, fraud against provincial or state government, tax evasion, or money laundering offences connected to these offences, can have serious practical implications for the local population.[37] Scholars point out that "corruption brings about diversion of financial resources from the national budget to private spending purposes".[38] If money destined for state coffers does not end up in the hands of parliament or trustworthy public officials, but disappears into the pockets of criminals, society will likely be harmed and suffer from insufficient infrastructure, public services and the like.

[32] Lawack "The South African banking system" in Sharrock (ed) *The Law of Banking and Payment in South Africa* (2016) 63 99; De Koker and Turkington "Transnational organised crime and anti-money laundering regime" in Hauck and Peterke (eds) *International Law and Transnational Organised Crime* (2016) 241 par 12.1 ("money laundering control became fused with the combating of financing of terrorism"; "money laundering and terrorism financing are linked in the global standards and in practice"); Zentes, Glaab, Becker and Heemann (n 26) 14 par 16/2; Ellinger, Lomnicka and Hare (n 26) 106 par (iii). See also Tricks *A Practitioner's Guide to Demand Guarantees* (2017) 163 par 10.6.2.

[33] Ellinger, Lomnicka and Hare (n 26) 93 (alterations by me).

[34] Altmann *Außenwirtschaft für Unternehmen* (2001) 599 *et seq*; Vento and Ohara "Practical considerations and risks for US companies contracting across borders" in Venoit, Brannan, Beaumont, Ness and Oles (eds) *International Construction Law* (2009) 13 21-22.

[35] Vento and Ohara (n 34) 22-24; Altmann (n 34) 613 *et seq*; Jungkind and Cramer "Boykott-Verbot versus Sanktionslisten-Screening" 2016 *AWPrax* 417.

[36] Ailshie and Eisenegger "International financial considerations" in Venoit, Brannan, Beaumont, Ness and Oles (eds) *International Construction Law* (2009) 165 185 *et seq*; Häberle *Handbuch für Kaufrecht, Rechtsdurchsetzung und Zahlungssicherung im Außenhandel* (2002) 635 par 6.7.2; Graf von Bernstorff *Forderungssicherung im Außenhandel* (2017) 34-36.

[37] Heimann and Pieth (n 24) 14 par 3. See also the remark made specifically regarding bribery and corruption in Uff (n 24) 20-21.

[38] Yikona, Slot, Geller, Hansen and Kadiri *Ill-Gotten Money and the Economy: Experiences from Malawi and Namibia* (2011) 5.

4 International efforts and initiatives against financial crime

International efforts and initiatives against financial crime within an international context are driven by nation states and their governments, international organisations,[39] and private initiatives, among them the United Nations, the European Union, and various groups comprising experts and representatives of stakeholders and industry experts.[40]

Of considerable importance are the United Nations, with its respective initiatives, bodies and offices such as the UN Security Council responsible for, inter alia, international sanctions or, for example, the United Nations Office of Drugs and Crime (UNODC) involved in the creation of the UN Convention against Corruption[41] and the drafting of model legislation and provisions on money laundering and terrorism financing. [42] With their far-reaching mandate under the Charter of the United Nations (articles 39 and 41),[43] the UN Security Council can impose economic sanctions and subsequently request all member states to implement and enforce them internationally.[44]

The European Union has issued legislation in the form of directives and regulations aimed at money laundering, terrorism financing and other aspects of organised crime for member states to implement and enforce across the

[39] Scholars have highlighted the involvement of international organisations especially regarding corruption and corruption prevention: see Makowicz "Der holistische Ansatz für Export Compliance Management" in Summersberger, Merz, Jatzke and Achatz (eds) *Außenwirtschaft, Verbrauchsteuern und Zoll im 21. Jahrhundert – Festschrift für Hans-Michael Wolfgang* (2018) 73 78 par 4.

[40] By no means could a paper such as this list all parties and organisations involved in this field. Therefore, brief introduction of some of the more relevant organisations should suffice.

[41] Adopted by the United Nations General Assembly in October 2003 as Resolution No. 58/4. For this aspect, see Heimann and Pieth (n 24) 103 *et seq*; Loughman and Sibery (n 21) 36-37; and Kubiciel and Rink "The United Nations Convention against Corruption and its criminal law provisions" in Hauck and Peterke (eds) *International Law and Transnational Organised Crime* (2016) 219 *et seq*.

[42] Madsen "Historical evolution of the international cooperation against transnational organised crime" in Hauck and Peterke (eds) *International Law and Transnational Organised Crime* (2016) 3 15 par 1.4.2. See, for example, the UNODC Model Legislation on Money Laundering and Financing of Terrorism (December 2005) or the UNODC Model Provisions on Money Laundering, Terrorist Financing, Preventive Measures and Proceeds of Crime (April 2009).

[43] A 39 reads: "The Security Council shall determine the existence of any threat to the peace, breach of the peace, or act of aggression and shall make recommendations, or decide what measures shall be taken in accordance with Articles 41 and 42, to maintain or restore international peace and security." A 41 reads: "The Security Council may decide what measures not involving the use of armed force are to be employed to give effect to its decisions, and it may call upon the Members of the United Nations to apply such measures. These may include complete or partial interruption of economic relations and of rail, sea, air, postal, telegraphic, radio, and other means of communication, and the severance of diplomatic relations."

[44] See Majlessi "Use of economic sanctions under international law: A contemporary assessment" in 2001 *Canadian Yearbook of International Law* 253 258 *et seq*; Pyka *Wirtschaftssanktionen der Vereinten Nationen und der Europäischen Union* (2015) 44 *et seq*; Birkhäuser *Sanktionen des Sicherheitsrats der Vereinten Nationen gegen Individuen* (2007) 22-23.

continent.[45] Certain European Union pronouncements, especially directives, require the individual member states to implement the European measures into their own domestic legal systems in order for them to be effective. Taking into account the combined economic importance of the member states of the European Union, its legislative and regulatory efforts do carry substantial weight.

Established by several industrialised nations in the late 1980s,[46] the Financial Action Task Force (FATF) is described as "the lead institution for international initiatives"[47] to fight money laundering and terrorism financing offences. As an intergovernmental organisation, FATF coordinates international policy making and enforcement, and issues authoritative guidelines and recommendations, which in turn are then used as models and adopted, implemented and enforced by the international community, individual countries and their respective governments.[48]

The Basel Committee on Banking Supervision was founded in the 1970s by industrialised countries and their central banks to address the increasing interconnectedness and interdependence of international banking operations,[49] which is done through research and the issuance of highly influential recommendations and guidance papers. Among the recent activities relevant for this paper are, for example, the publication of guidelines relating to risk management in the context of money laundering and terrorism financing.[50]

The United States of America has been the "first jurisdiction to tackle money laundering",[51] and remains very active with numerous offices, bureaus, and entities engaged in combatting financial crime. The regulatory activities of the USA are closely watched by experts around the globe and often used as a yardstick, adopted, implemented, or otherwise complied with,[52] as many of their financial institutions and market places play, "[d]espite Washington's current protectionist leanings",[53] a major role in international trade and finance.

Aside from the actors and institutions mentioned above, several private initiatives such as the Wolfsberg Group, the American lobbying organisation Bankers Association for Finance and Trade (BAFT) and the International Chamber of Commerce (ICC) have contributed to the field, either individually or collectively,[54] with research, recommendations, and guidance papers. In light

45 Hecker "The EU and the fight against organised crime" in Hauck and Peterke (eds) *International Law and Transnational Organised Crime* (2016) 63 78-81.

46 Stroligo, Intscher and Davis-Crockwell *Suspending Suspicious Transactions* (2013) 5-6.

47 Ellinger, Lomnicka and Hare (n 26) 94.

48 Stroligo, Intscher and Davis-Crockwell (n 46) 6; Ellinger, Lomnicka and Hare (n 26) 95; De Koker and Turkington (n 32) 247 par 12.3.3.

49 Ellinger, Lomnicka and Hare (n 26) 77.

50 Basel Committee on Banking Supervision (n 15).

51 A claim made by Ellinger, Lomnicka and Hare (n 26) 93.

52 See Schoppmann *Compliance als Organisationspflicht bei Kreditinstituten* (2014) 12 and 16.

53 HSBC *Global Report – Navigator Now, Next and How for Business* (2018) 6 www.business.hsbc.com/trade-navigator (02-07-2018) (alteration by me).

54 The Wolfsberg Group, ICC and BAFT (n 3), the so-called "Wolfsberg Principles".

of the remarkable legislative and regulatory activities, and the large number of intergovernmental and non-governmental organisations and their research and policy-guidance output, it is becoming increasingly difficult to assess, and comply with, all current expectations and legal requirements. Accordingly, experts conclude that "far reaching regulations have changed the compliance and risk management landscape".[55] Many banks and companies struggle to introduce and operate appropriate internal compliance programmes and mechanisms to ensure that all their activities are in line with applicable rules and regulations.

For purposes of this paper, it is not necessary to distinguish clearly between applicable legislation and regulatory measures, violation of which may result in criminal or administrative penalties, and recommendations, sourcebooks, guidance or position papers by non-governmental or lobbying organisations, that attempt to articulate best practices or recommendations and the violation of which cannot, directly, lead to criminal or administrative liability. What is important to note, at this point, is the fact that some referenced guidance, recommendations or position papers by certain organisations do in fact carry substantial weight. They do not have the force of law, of course, but they will often be appreciated and used by regulators, bank examiners and law enforcement as blueprints for appropriate behaviour and compliance. Therefore, despite the lack of legal force some recommendations or guidance papers ought to be seen as authoritative and highly significant, because they, effectively, articulate or shape the expectations of law enforcement, bank examiners, and regulators. Scholars emphasise the influence that such organisations, for example the Basel Committee on Banking Supervision, can have in this regard. As Ellinger, Lomnicka and Hare put it "[the Basel Commitee] has neither formal legal status nor authority, but its recommendations (so-called 'soft law') are enormously influential and are followed by banking regulators throughout the world."[56]

Overall, it is evident that the area of compliance with measures aimed at countering financial crime is complicated to navigate. It has been acknowledged, therefore, that "the legal environment is increasingly complex. In addition to the array of national and international laws, regulations, and other authorities that govern transnational criminal law enforcement, one must consider the independent activities of influential transnational actors."[57]

4.1 *Data, due diligence, and the risk-based approach*

Certain issues and concepts permeate almost all modern initiatives of financial crime prevention and compliance with measures aimed at combatting financial crime. Most important, it is the notion that data and information relating to the

[55] FATF *Discussion Paper No.1 - Global Impact and Unintended Consequences for Exclusion and Stability* (2014) 4, available at https://classic.regonline.com/custImages/340000/341739/G24%20AFI/G24_2015/De-risking_Report.pdf (02-07-2018).

[56] (n 26) 77 (insertion by me).

[57] Kuester "Transnational influences on financial crime" 2013 *University of Miami National Security and Armed Conflict Law Review (Symposium Edition 2013-2014)* 71 79.

identity of parties, their transactions and business pattern must be scrutinised and used to identify signs or evidence relating to financial crime, as well as the risk-based approach[58] which is linked to the particular level of due diligence and scrutiny that is appropriate for a specific customer or transaction. Typically, there is a distinction made between regular due diligence, which can be either heightened (typically referred to as enhanced, raised, elevated, or escalated) or, in some cases, even lowered when appropriate. Due diligence can relate both to the customer, meaning the person or entity for whom the bank provides a service, or the transaction that is being facilitated by the bank. Most recent regulations, initiatives and approaches contain elements relating to customer profiles and respective data, the so-called "know your customer or client" (KYC) requirements, and recommend or require information gathering at the point in time in which the person or entity becomes a customer (the so-called on-boarding stage), but also at regular intervals during the customer-bank relationship (on-going or constant monitoring), for instance when transactions are requested or executed, or other significant changes in the customer profile or its commercial activities occur.

4.2 *Risk indicators of financial crime*

The risk-based approach and the variable levels of due diligence are typically linked to collections or lists of risk indicators (so-called red flags), the presence of which may be used to estimate the likelihood or chances of a certain customer or transaction being criminally motivated and the potential risks associated with that, which in turn will determine the appropriate level of due diligence required to satisfy regulators' and examiners' compliance expectations under a maintained and executed compliance programme or applicable legal regime. Prominent examples of such risk indicator lists have been issued, for instance, by FATF,[59] or by the United Nations Commission on International Trade in regard to commercial fraud.[60]

However, domestic bodies or government agencies have also issued lists of risk indicators, such as the United Kingdom's Financial Conduct Authority

[58] For the introduction and application of the risk-based approach within the South African context, regard may be had to Hugo and Spruyt "Money laundering, terrorist financing and financial sanctions: South Africa's response by means of the Financial Intelligence Centre Amendment Act 1 of 2017" 2018 *Journal of South African Law (TSAR)* 227 236 *et seq*; and Spruyt "The Financial Intelligence Centre Amendment Act and the Application of a Risk-Based Approach" in Hugo and Du Toit (eds) *Annual Banking Law Update (ABLU)* (2017) 19 21 *et seq*. See, generally, Heimann and Pieth (n 24) 131-132.

[59] FATF has included risk indicators in many of its publications, for example in FATF *Report on Money Laundering/Terrorist Financing Risks and Vulnerabilities Associated with Gold* (July 2015) 20-23; FATF *Report on Risk of Terrorist Abuse in Non-Profit Organisations* (June 2014) 68-73; FATF *Report on Money Laundering and Terrorist Financing Vulnerabilities of Legal Professionals* (June 2013) 77-82; and FATF *Money Laundering & Terrorist Financing Through the Real Estate Sector* (June 2007) 34-37.

[60] UNCITRAL (n 26) 11 *et seq*.

(FCA),[61] the Monetary Authority of Singapore (MAS),[62] the Financial Transactions and Reports Analysis Centre of Canada,[63] or the American Federal Financial Institutions Examination Council (FFIEC).[64] In South Africa, for instance, the Financial Intelligence Centre's Guidance Note 7[65] provides several possible risk indicators that relate to, *inter alia*, the question whether the customer's product has "a 'cooling off' period which allows for a contract to be cancelled without much formality and a refund of moneys paid",[66] or whether "the client's product selection [is] rational with a view to support their business or personal needs".[67] In Germany, for example, the "Anhaltspunktepapier Geldwäsche" was issued by the competent German authority[68] in conjunction with representatives from major banks, insurance companies, and financial institutions, and updated recently.[69] It contains indicators which may point to money laundering, among them a section specifically dealing with commercial letters of credit and documentary collections. According to that paper, possible indicators of money laundering can be the use of trade finance instruments in transactions which concern countries that are considered "politically and economically"[70] stable if the particular industry does not, typically, utilise traditional trade finance products for such transactions. One of the other mentioned indicators is the utilisation of "letters of credits and other international trade finance products if the use of such instruments is, in consideration of the known commercial activities of the customer, unusual".[71] A similar list of indicators was issued by German authorities which relates to possible terrorism financing transactions.[72] Among numerous other potentially suspicious facts or behaviour, the mere request by a bank customer to "invest money with the instruction to generate no or only little interest (Islamic Banking)"[73] is listed as a possible red flag.

61 FCA *Thematic Review – Banks' Control of Financial Crime Risks in Trade Finance* (July 2013) 46-48.

62 MAS *Guidance on Anti-Money Laundering and Countering the Financing of Terrorism Controls in Trade Finance and Correspondent Banking* (October 2015) 19-21.

63 FINTRAC *Guideline 2 – Suspicious Transactions* (June 2017) par 7-8.

64 FFIEC *Appendix F – Money Laundering and Terrorist Financing "Red Flags"*.

65 Financial Intelligence Centre *Guidance Note 7 on the Implementation of Various Aspects of the Financial Centre Act, 2001 (Act 38 of 2001), October 2017*.

66 17.

67 20 (insertion by me).

68 The German "Zentralstelle für Verdachtsmeldungen".

69 Bank-Verlag *Mitarbeiterinformation zur Abwehr von Geldwäsche und Terrorismusfinanzierung* (2018) 171.

70 My translation. The original German (184 par 5.3) reads "politische und wirtschaftliche Verhältnisse eine sichere Form der Zahlungsabwicklung zulassen".

71 The translation is mine. The original German (184 par 5.1) reads "Verwendung von Akkreditiven und anderen Methoden der internationalen Handelsfinanzierung, wenn solche Instrumente bei den bekannten geschäftlichen Aktivitäten des Kunden unüblich sind".

72 See Bank-Verlag (n 69) 201 *et seq*.

73 The translation is mine. The original German (205 par 2.1) reads "Anlage von Geldern mit der Maßgabe, keine oder nur geringe Zinseinkünfte zu erzielen ('Islamic Banking') ".

As expressly pointed out, for example by the MAS in its risk indicator list "Guidance on Anti-Money Laundering and Countering the Financing of Terrorism Controls in Trade Finance and Correspondent Banking", the presence of a particular risk indicator cannot be treated as conclusive evidence:

> "Banks should pay attention to the following red flags when processing trade finance transactions of their customers as they could be indicative of a transaction being used for financial crime purposes. These examples are not exhaustive, and the presence of a single red flag indicator does not mean that the transaction is illegal. A confluence of multiple indicators would nonetheless suggest that the transaction is suspicious, and appropriate due diligence measures, including [Suspicious Transaction Report] filing, should be adopted by the bank."[74]

In practice, risk indicator lists play an important role for banks when operating a compliance programme and conducting due diligence compliance checks.

5 The effectiveness and usefulness of increased efforts and initiatives aimed at combatting financial crime

Although it is difficult, if not impossible, to measure precisely the effect of recent efforts and initiatives to combat financial crime, it is probably reasonable to assume that the increase in regulatory expectations and scrutiny has had a positive impact in that it reduced the number of criminal transactions processed or facilitated through the established formal financial system. This assumption is based on the notion that increased scrutiny will, naturally, uncover illegal transactions, and deter criminals from utilising the financial system and trade finance products for criminal purposes. In 2015, BAFT reported the following:

> "Regulators have focused intense scrutiny on trade finance as a potential conduit for financial crimes, including money laundering and terrorist financing. Bank examiners have heightened their expectations concerning customer due diligence, sanction filtering, and suspicious activity identification related to trade finance. "[75]

All this is likely to have contributed to curbing or reducing instances of financial crime.

Harsh penalties and sanctions can, and have been, imposed on banks, financial institutions, companies and persons that violated laws and regulations aimed at fighting financial crime which include, *inter alia*, substantial monetary fines,[76] suspension of banking licences or the threat thereof,[77] freezing of assets, closer scrutiny and the permanent or temporary embedding of dedicated compliance examiners into a bank or financial institution, or measures aimed

[74] MAS (n 62) 19 (alteration by me).

[75] BAFT (n 19) 1 (their footnote omitted).

[76] Various examples are supplied, for example, in Vogt "Compliance mit US-Sanktionsregelungen zu Iran mit extraterritorialer Wirkung" in Huck and Kurth (eds) *Compliance aus dem Blickwinkel des internationalen und europäischen Wirtschaftsrechts* (2013) 97 101-102; and Fleischmann *Globalisierbarkeit von Compliance-Erwartungen?* (2016) 140-143.

[77] Habib Bank, for example, surrendered its banking licence for New York State after repeated money laundering offences and an agreement to close, permanently, its branch in New York City. See April 2018 *Documentary Credit World (DCW)* 30.

at personnel such as travel bans for senior executives and the risk of personal arrests, mandating that specific banking officers and management personnel be terminated or additional compliance personnel be hired. Besides that, more informal punishment or pressure can include the banning or overlooking of bidders or bids in or from certain countries or regions,[78] the rejection or revocation of insurance cover for engineering or construction projects, export transactions[79] or ocean voyages,[80] or actions such as the disconnection from the important SWIFT communications network.[81] In addition, reputational damage caused by allegations of compliance violations can be devastating for a bank, financial institution, company, or natural persons who will encounter difficulties after having been associated with financial crime. In consideration of this, one could come to the conclusion that increased and stricter initiatives aimed at combatting financial crime have had, and will continue to have, a crime-reducing and thus positive effect.

However, one should also be cognisant of other data when assessing the effectiveness of increased regulatory expectations and enhanced scrutiny efforts. The ICC, in a comprehensive international survey, discovered that "nearly 20% [of banks] said they have no visibility on whether their efforts linked to monitoring due diligence and transactions have improved results, or not".[82] Also, it remains doubtful whether traditional trade finance products such as documentary collections and letters of credit, in the first place, merit scrutiny and attention on the present scale – especially because such enhanced scrutiny and regulation has had, and is likely to have in the future, some serious unintended practical consequences that are explored immediately below.

6 Unintended consequences of increased and stricter compliance rules and regulations: Legal uncertainty, increased cost for compliance matters, de-risking, and clean payment trading as an emerging alternative

Stricter and expanding compliance requirements relating to the combatting of financial crime have given rise to several unintended consequences for international banking and trade finance. A serious problem is the element of uncertainty that originates from the flexible and discretionary approach that

[78] See, for example, Fleischmann (n 76) 148-149; and Heimann and Pieth (n 24) 213.

[79] Heimann and Pieth (n 24) 213.

[80] This makes international shipments, and thus a significant aspect of international trade, virtually impossible, and has been applied in the past, for example, against Iranian entities.

[81] The Belgium-based Society for Worldwide Interbank Financial Telecommunication (SWIFT) operates an international network for secure and authenticated communication and messaging. The network is primarily used by banks and financial institutions, and carries electronic communications relating to finance, trade, international payments, letters of credits, and other inter-bank messages. Many Iranian banks were disconnected from the SWIFT network from 2012-2016, a move that severely impeded their ability to carry out international transactions. Sudanese banks suffered from a similar fate until 2017; see Bälz and Mujally "Handel mit Sudan" 2017 *Recht der Internationalen Wirtschaft (RIW)* 201.

[82] ICC *2018 Global Trade – Securing Future Growth* (2018) 50 (insertion is mine).

many recent regulatory measures and initiatives take. While many concepts and notions, most importantly the emergence of a risk-based approach, allow for checks and responses which are potentially more in line with the likely, actual risk of a particular customer or transaction,[83] they introduce a considerable element of uncertainty. It falls on the bank or financial institution to assess correctly the level of risk associated with a particular customer or transaction, and subsequently to carry out the appropriate risk detection and mitigation activities.[84] If the initial risk classification (low or high risk?), or whichever the applicable categories in a given jurisdiction or compliance regime are, fails, then the subsequent actions taken by the bank or financial institutions are likely to be insufficient (problematic transaction wrongly identified as low risk and thus escaped further scrutiny) or unwarranted and excessive (low risk transaction subjected to too-intense a scrutiny or even unnecessarily reported to the competent authority as suspicious). The problem is that if the initial risk classification exercise fails, either the transaction or the customer may not have been properly scrutinised, and resources dedicated to financial crime compliance – scarce as they are – are being applied inefficiently. It remains a reality that each case of a customer relationship or a transaction is different, and the risk-based approach necessitates decision making on a case-by-case basis.[85]

6.1 *Uncertainty*

Even if the bank applies the available indicators of financial crime in accordance with applicable legislation and regulations, it is not always clear what exact steps need to be taken subsequently. Depending on the applicable compliance regime, for example, "enhanced due diligence" needs to be conducted or "appropriate measures" may have to be taken in relation to a particular transaction or customer. What exactly such elevated due diligence or appropriate measures are, however, is often left open to interpretations by bankers or their lawyers and advisers and, ultimately, bank examiners, financial auditors, and courts. Therefore, Byrne and Berger have spoken of an "unsettling element of vagueness", and have expressed the following criticism:

[83] This notion is aptly explained by Spruyt (n 58) 21 par 2 who writes: "[a]n effective AML/CFT [anti-money laundering/counter-terrorism financing] framework should rather ensure that resources are effectively channelled to and concentrated on areas that represent a higher risk of abuse. Consequently, it should also be possible to devote less resources where the risk is lower. By applying enhanced measures and controls where the money laundering (ML) and terrorism financing (TF) risks are higher, with the option of applying simplified measures where the risks are lower, accountable institutions can target their resources more effectively, whilst ensuring that these risks are efficiently mitigated. The application of resources that are commensurate to the risks that are being managed and mitigated, can be described as a risk-based approach." (alterations, insertion, and omission of his footnotes by me.)

[84] Spruyt (n 58) 21 par 2.

[85] See, for example, Scherp *Bank & Compliance Mitarbeiterinformation zur Verhinderung von Betrug und sonstigen strafbaren Handlungen* (2018) 18.

> "A bank must take 'appropriate' measures, it must exercise 'due diligence', and act 'reasonably'. There is, however, no clear definition as to what is sufficient or satisfactory. Whether intentional or not, this approach leaves the bank potentially exposed if certain steps are not taken […]. Given the importance of (legal) certainty for commercial transactions and banking and finance in general, this is worrisome."[86]

But uncertainty in the context of compliance with measures against financial crime also stems from the fast pace[87] with which compliance requirements and regulatory expectations emerge, and from the large number of actors and sources (governments, inter-governmental bodies, international organisations and initiatives) that issue relevant lists of sanctioned entities or goods, literature with guidelines and principles, and authoritative interpretations or best-practice formulations. Since banks active in international trade and trade finance are necessarily operating in several jurisdictions, either directly through branches and subsidiaries of their own or through correspondent intermediaries, their compliance tasks are considerably more complex because they need to ensure compliance in all operative jurisdictions and markets. In this regard, one author concludes that "[t]he extent of the due diligence will depend on the bank's internal procedures and the local regulations applicable to the bank. […] Since the regulations will vary from country to country, it is not possible to set out a single standard"[88] for financial crime compliance. If one applies this thought to the African continent in particular, one will have to agree with the negative assessment of the president of the African Export-Import Bank, Benedict Oramah, who observed that "[t]he compliance cost is high. Africa is fragmented – it has 55 countries".[89] Especially in consideration of financial inclusion and the continent's need for access to banking facilities and trade support, this is clearly problematic.

The compliance matrix is further expanded by extraterritorial application of laws and regulations by some countries, most notably the United States of America (also referred to as long-reach or long-arm approach or legislation) in matters of, inter alia, sanctions.[90] By treating transactions that are nominated

[86] Byrne and Berger (n 19) 62 par 3.6.1 (omission by me).

[87] Kuester (n 57) 78 speaks of "the fast-moving pace of change in world-wide financial crime regulations".

[88] Tricks (n 32) 170 par 11.2.2 (omission, alteration and insertion by me).

[89] Interview by Manders in 2018 *Global Trade Review May Issue* https://www.gtreview.com/news/africa/exclusive-afreximbank-president-unveils-new-initiatives-and-thoughts-on-africas-trade-finance-gap (02-07-2018) (alteration by me).

[90] See Dixon *International Law* (2013) 156-158; Haellmigk "Das aktuelle US-Iran-Embargo und seine Bedeutung für die deutsche Exportwirtschaft" 2018 *Corporate Compliance Zeitschrift (CCZ)* 33; Huck "Extraterritorialität US-amerikanischen Rechts im Spannungsverhältnis zu nationalen, supranationalen und internationalen Rechtsordnungen" 2015 *Neue Juristische Online-Zeitschrift (NJOZ)* 993; Battini "Globalisation and extraterritorial regulation: An unexceptional exception" in Anthony, Auby, Morison and Zwart (eds) *Values in Global Administrative Law* (2011) 61 63 *et seq*; Vento and Ohara (n 34) 29; Byrne and Berger (n 19) 64 par 3.8; and generally Huck and Kurth *Compliance aus dem Blickwinkel des internationalen und europäischen Wirtschaftsrechts* (2013).

in US-Dollars, in some cases irrespective of where contract formation takes place, where goods or services are exchanged or delivered, and where parties are domiciled, to be subject to US-American law, the United States of America, effectively, imposes its own compliance expectations onto the global financial network and international banking and trade.

Uncertainty due to complex and extensive, ever-changing compliance requirements is especially challenging for smaller banks and such established in emerging countries that do not have the financial or operational capacity to react immediately, many of which "find recent regulatory complexity challenging".[91]

Additionally, the stricter and more intense scrutiny of customers and transactions in international trade finance has led to an increased number of hits or alerts, correct or incorrect, when conducting manual or automated checks on transactions, customers or their trade partners. The fear of failing to report a suspicious transaction, and the subsequently danger of fines and other sanctions, may motivate what is sometimes referred to as "over-reporting". This can be due to an overzealous reporting culture in a bank or financial institution or, for example, due to an unadjusted or incorrect application of "fuzzy search" options which, for example, may capture a variety of ways of spelling the name of a person[92] or entity and therefore yield numerous hits. These hits become so-called false positives if subsequent manual checks are not carried out properly to reduce the alerts to relevant cases only.[93] Investigating unnecessarily large numbers of suspicious transaction reports drains resources, both at the compliance stage internally at banks, and also subsequently when competent authorities investigate the received reports.

6.2 *Increased costs*

Another unintended and negative consequence of more intense regulatory activity, which in turn leads to more compliance-oriented efforts by banks, financial institutions, and companies, is an increase of the overall costs to conduct business. The implementation of new and stricter compliance measures within a bank and enhanced checks and scrutiny of international trade finance transactions comes with a price tag, as compliance protocols are designed and implemented, expert staff is hired, databases and third-party automated checking applications are subscribed to, and other external expertise is sought. Banks are likely to pass on the increased transactional costs to their immediate customers. These immediate customers will themselves attempt to avoid being affected by such additional costs, and thus initiate a ripple effect whereby the

[91] IFC *De-Risking and Other Challenges in the Emerging Market Financial Sector* (2017) 18.

[92] Consider the following example that revolves around the spelling of a very common name which knows many variations, such as Muhammad, Muhamad, Mohammad, Mohamed, Mouhamed, etc.

[93] Burkert-Basler and Nawrotzki "EU-Sanktionslistenprüfung" 2016 *AWPrax Service-Guide* 23 26.

added transactional costs are relayed along the business chain, in many cases ending with the consumer of imported goods or services.

However, in some cases the additional expenses related to stricter regulatory measures and compliance expectations are too significant to be passed on – adding them to the overall costs for a particular trade finance product such as a commercial letter of credit or documentary collection service would render them too expensive. This can result in down-scaling or even termination or discontinuation of customer and correspondent-bank relationships due to increased due diligence requirements to maintain customer accounts or correspondent relationships, or the decision to refrain from forging new relationships with potential customers and correspondents because the prospect of conducting enhanced due diligence exercises in a significant and continuous manner cannot be justified financially or from an operational perspective – this phenomenon is called "de-risking".

6.3 *De-risking*

De-risking describes a process whereby banks or financial institutions (or even companies) terminate commercial relationships, or decide not to seek new relationships, with parties from certain regions or countries, or from certain sectors and industries.[94] De-risking can range from refusing a particular finance request, declining the application of a prospective customer to open an account or access banking facilities, or even the termination of an existing customer or correspondent-banking relationship. This way banks, effectively, reduce or eliminate their potential exposure to what is perceived as a risk from a compliance perspective. Accordingly, the number of correspondent-bank relationships has declined sharply in recent years.[95] However, this means that certain countries or regions will increasingly lack access to trade finance products,[96] or where parties located in these countries or regions do manage to access trade products, will face increased costs and cumbersome application procedures. This problematic development is also discussed by Wass, who reports the following:

> "De-risking has had unintentional and costly consequences, especially in Africa, Central and Eastern Europe, and Asia Pacific. Among the biggest losers are small businesses that can't access working capital or trade finance. As correspondents depart, they've left holes in the funding space, cutting credit lines and withdrawing finance."[97]

[94] FATF (n 55) 5.

[95] See the extensive literature review provided in IFC (n 91) 16-17.

[96] See Woodsome and Ramachandran *Fixing AML – Can New Technology Help Address the De-Risking Dilemma?* (2018) vii, who state that "small and fragile countries have been especially affected" by the decline in correspondent banking relationships; and ICC (n 82) 97: "Coupled with the continued retreat of many global banks from the continent due to business, regulatory and KYC compliance considerations, many local banks in Africa suffered from inadequate correspondent banking lines and insufficient foreign currency liquidity to finance trade."

[97] Wass "Could regtech bridge the trade finance gap in emerging economies? " 2018 *Global Trade Review* www.gtreview.com/news/fintech/could-regtech-bridge-the-trade-finance-gap-in-emerging-economies (02-07-2018).

A recent statement by the Financial Stability Board (FSB) generally confirmed this assessment by warning that

> "[t]he reduction in correspondent banking relationships may affect trade finance transactions that rely on correspondent banking arrangements to be processed, and may thereby impact some countries, especially those that depend on trade for their development or the access to basic supplies."[98]

Especially smaller banks are likely to struggle to meet all compliance requirements by establishing and maintaining a comprehensive compliance programme, and are more likely to withdraw from certain jurisdictions or refuse certain customers. Yet it has been noted that de-risking is by no means restricted to small banks, and that some larger financial institutions have also chosen this approach in response to the increasing compliance expectations.[99] Overall, and without particular distinction between small or large banks, it has been argued that "uncertainty about exposure to risk and the costs arising from a tightening of the regulatory environment have been important factors influencing current de-risking decisions".[100]

6.4 *Clean payment (advance payment and open account trading) as an emerging alternative*

In light of this trend, local businesses active in the international sale of goods and services might have to decrease, or possibly even cease, their own trade activities, or consider alternatives. One emerging alternative is to adopt clean payment trading such as advance payment or open account terms and this development, in fact, has been noticed within the international trade and banking industry.[101] As was indicated above, advance payment and open account trading reduces the involvement of banks. Instead of handling and examining documents relating to the underlying trade transaction, clean payment agreements deprive banks of a significant portion of the data derived from trade documents and thus insight into the underlying transaction.[102] The scholars Ehrlich and Haas point out that the involvement of banks in advance payment or open account schemes is, typically, limited to the funds transfer, and can mean that the banks do not know whether a legitimate – or in fact *any* – underlying transaction exists between the sender and the recipient of the money.[103] This is confirmed as follows in a publication of the Wolfsberg Group, ICC and BAFT:

[98] Financial Stability Board *Action Plan to Assess and Address the Decline in Correspondent Banking* (2018) 8 (alteration by me).

[99] Woodsome and Ramachandran (n 96) 2.

[100] FATF (n 55) 6.

[101] See, for example, ICC (n 82) 14. It should be acknowledged, however, that the increase in open account transactions is not exclusively due to de-risking trends but may be motivated by several factors (*inter alia*, the rise of discrepancies in letter of credit presentations).

[102] BAFT (n 27) 2-4.

[103] Ehrlich and Haas (n 7) 344 par 4/3. The original German reads "Die Banken werden mit der Abwicklung eines solchen Geschäfts i.d.R. erst dann befasst, wenn ihnen der Auslandszahlungsauftrag des Käufers zugeht. Welche Zahlungsmodalitäten Käufer und

> "Participants to an Open Account Trade transaction do not look to banks to provide financing related to each specific purchase, and generally finance the transaction out of their own cash flow or through other arrangements. Banks will likely be indirectly involved in the financing of the trade transaction through bank-provided overdraft facilities, revolving lines of credit, post shipment or inventory financing, but will not have information as to the specifics of the trade transaction as is the case in documentary trade. […] The seller and buyer will generally not provide the banks handling the Open Account payment with supporting documentation; in the majority of cases, banks will have little inherent opportunity, need, or cause to understand the nature of the underlying trade transaction, or to review any trade-related documentation (e.g., contracts, invoices, shipping documents)."[104]

Therefore, it is obvious that the data gathered in a clean payment transaction is less detailed in comparison to data and information collected and reviewed in transactions supported by documentary collections or letters of credit.

6.5 Unmitigated trade risks and reduced transactional insight

The move towards open account and other clean payment trading terms as a result of de-risking strategies of banks and financial institutions is problematic in two ways which concern the parties themselves, but also the system of combatting financial crime in general.

First, conducting international trade on a clean payment basis exposes the trading parties to considerable risk of insufficient or non-performance. This risk can materialise to the disadvantage of the seller when opting for open account terms, that is the seller or service provider not being paid (in full and on time) after it has relinquished control over the goods or services. When choosing advance payment terms the contract risk falls on the buyer, who may not receive satisfactory merchandise or services after having parted with its money. The respective risks, either on the seller or the buyer, would have been prevented or at least mitigated by the utilisation of documentary collections or letters of credit – without immediate payment[105] the bank will not release the trade documents to the buyer (documentary collection transaction), and without tendering compliant documents the bank will not honour a letter of credit (letter of credit transaction).

Secondly, as was pointed out, open account transactions reduce the involvement of banks and their handling of documents with the direct result of no, or severely reduced, transactional insight. If the parties engage banks solely for the purpose of wiring the appropriate amount, then

Verkäufer hinsichtlich eines Zahlungszieles, der Gewährung von Ratenzahlungen usw. vereinbart haben, erfahren die Banken nicht. Dort, wo eine diesbezügliche Angabe nicht aus devisenrechtlichen Gründen unumgänglich ist, brauchen die Banken nicht einmal zu wissen, ob der Zahlung überhaupt ein Warengeschäft zugrunde liegt."

[104] The Wolfsberg Group, ICC and BAFT (n 3) 65 par. 1.5 and 1.6 (omission by me).

[105] or acceptance of a draft if so agreed upon.

> "banks usually have only the name, address and account number of the payment originator (buyer) and name and account number of the payment beneficiary (seller). The payment is typically processed without human intervention via systems in the bank's wire transfer department."[106]

The data and information that is usually gathered through the trade finance instrument will not be available to the bank. Without information relating to the underlying transaction and its parties there can be no effective monitoring of compliance with measures aimed at combatting financial crime. BAFT has provided two instructive tables indicating visibility, or lack thereof, for the most common transaction types encountered in international trade, which clearly show the poor potential for scrutinising documents and identifying some of the financial crime indicators (and thus criminal transactions) in open account or advance payment transactions (as opposed to documentary collections and letter of credit transactions).[107]

The drive towards clean payment terms, obviously, directly undermines the initial intention of obtaining more transactional scrutiny by imposing stricter and more extensive compliance requirements on banks involved in traditional trade finance and respective products such as documentary collections and letters of credit. It stands to reason that the increase of legislative and regulatory activity may, because of de-risking trends, practically lead to less insight in many instances. BAFT has summarised this very issue, aptly, as follows:

> "The only role for the bank [in an open account transaction] is processing the payment to settle the transaction. The bank has no knowledge or visibility to the underlying trade transaction as it was not bank-intermediated, and therefore, has limited ability to identify illicit trade behaviour."[108]

One may wonder whether the current international approach to financial crime and traditional trade finance instruments that is defined by accelerated legislative and far-reaching regulatory activities, and the subsequent unfortunate trends of de-risking and the rise of clean payment trading, could and should be reconsidered in order to achieve the initial goal of transactional oversight and compliance with measures against financial crime.

It is not suggested that such and respective due diligence should be stopped for trade finance products. However, the current focus on traditional trade finance products such as documentary collections and letters of credits is probably ill-placed and does not represent the most efficient way of channelling and applying compliance resources.

7 Conclusion

Compliance with measures aimed at combatting financial crime is a changing and evolving field, shaped by various governmental and non-governmental actors, whose actions may or may not have direct legal force but nevertheless

[106] BAFT (n 27) 4.
[107] BAFT (n 27) 13-14.
[108] BAFT (n 27) 2 (insertion by me).

impact upon the compliance regime and translate into respective expectations. Changing and expanding financial crime legislation makes it increasingly difficult and cumbersome for banks and other parties involved in international trade and international trade finance to comply with applicable laws, regulations, and codifications of best practice. In many cases, banks have responded by limiting their risk exposure and involvement with respect to certain customers, correspondent banks or markets. Significant de-risking decisions have been reported in international banking and trade finance which, in turn, have contributed to the emergence of clean payment trading terms in international contracts. Clean payment transactions, regrettably, deprive banks of transactional oversight and therefore limit their capabilities of identifying and reporting financial crime. The unintended consequences of de-risking and clean payment terms run counter to the initial aim of increasing customer and transactional monitoring and insight to scrutinise data for signs of financial crime. Therefore, re-adjusting the focus of compliance with measures aimed at combatting financial crime should be considered since the current emphasis on documentary collections and letters of credit is not, arguably, the most efficient way of approaching the threat of international financial crime within the international banking and trade sector.