Combating trade-based money laundering - Hong Kong banks bolster their artillery

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Hong Kong February 3 2016

The Hong Kong Association of Banks (**HKAB**) has just issued its much anticipated Guidance Paper on Combating Trade-based Money Laundering (**Guidance Paper**). The Guidance Paper is a valuable resource for the Hong Kong banking industry in combating one of the oldest forms of money laundering.

This article summarises the key themes and content of the Guidance Paper.

Status of the Guidance Paper

As an industry-led paper, the practices in the Guidance Paper do not form part of the Guideline on Anti-Money Laundering and Counter-Terrorist Financing (for Authorized Institutions) (**AMLO Guideline**).

However, the Guidance Paper was prepared in collaboration with the Hong Kong Monetary Authority (**HKMA**) and the HKMA considers that adopting the Guidance Paper's practices will assist authorized institutions (**AIs**) to meet their obligations under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (**AMLO**) and the AMLO Guideline, and mitigate their money laundering and terrorist financing (**ML/TF**) risks.

AIs should take note. There is no "grace period" as such.

Why this paper is needed

The Basic Law enshrines Hong Kong's status as an international financial centre. Trade and the financial system are two critical component of any financial centre and it is therefore imperative that Hong Kong's banking system is well equipped to combat the risks of trade-based money laundering (**TBML**).

Key themes

The Guidance Paper covers the full gamut of components of an effective anti-money laundering and counter-terrorist financing (AML/CTF) regime.

Click here to view the table.

A snapshot of the Guidance Paper

1. Defining TBML

The keys concepts used throughout the Guidance Paper are as follows:

- **TBML**, which captures TBML and terrorist financing through trade transactions consistent with current Financial Action Task Force (FATF) Guidance*, but also sanctions violations and weapons of mass destruction proliferation.
- **Trade transactions**, which captures transactions in respect of good or services between a buyer and seller.
- **Trade-related activities**, which captures activities carried out by AIs involving trade transactions.

** The most recent FATF Guidance was the "Best Practices on Trade Based Money Laundering" on 20 June 2008.*

The Guidance Paper recognises that there is no exhaustive list of trade-related products and services, instead providing examples of typical products or services. These include:

Click here to view the table.

The key AMLO concept of **"Who is the customer"** is outlined with Annex A, illustrating two key parts of a typical letter of credit ("**L/C**") structure and providing guidance of who would typically constitute the "customer". Importantly, one size does not fit all.

2. Trade Controls

The Guidance Paper reminds AIs of the importance of developing written policies and procedures to assess and mitigate ML/TF risks arising from trade-related activities ("**Trade Controls**").

Key principles relating to Trade Controls are as follows:

Click here to view the table.

None of these Trade Controls should be a surprise to AIs, but the Guidance Paper applies a direct "trade based" flavour to each of these principles.

The Guidance Paper also highlights the importance of good transaction review processes. Helpfully, a sample review process is outlined demonstrating best practice and the expertise required at each level of review. However, this is a sample only, so AIs should not panic if their internal review process does not match exactly; AIs should tailor their review processes according to their needs (as with all AML processes).

3. Risk assessment and the risk-based approach

Ask any regulator what is an effective way to combat ML/TF, and they will tell you the risk based approach (**RBA**). We expect the HKMA is likely to say that based on the AMLO Guidelines (paragraph 3.1).

It is no different for TBML – AIs should adopt an RBA to their customer due diligence (CDD) obligations in accordance with Chapter 3 of the AMLO Guidelines and any other factors related to trade activities. Part 1 of Annex B of the Guidance Paper helpfully sets out typical TBML typologies to steer AIs in the right direction of what to look for and information to obtain.

Expensive toothbrushes?

For example, **over-invoicing**, is where there is a mismatch in the invoice value and the fair market price of a good or service. Part 1 of Annex B advises AIs of information that might be relevant to assessing the ML/TF risk of over-invoicing: product category, product description, unit price and units. Armed with this information, an AI, for example, that receives an invoice for 10,000 units of toothbrushes at USD10/unit is placed to assess the ML/TF risk in respect of this transaction and whether this is usual (for the record, we expect it is not).

4. Trade-related CDD requirements

CDD is vital for recognising ML/TF and a fundamental requirement of the AMLO.

In addition to the general CDD obligations under the AMLO and AMLO Guideline, the Trade Control specific CDD tips set out in the Guidance Paper include:

- **collect the information that matters:** collect customer information related to trade-based activities, for example, business nature, major suppliers and buyers, delivery / transportation mode for goods and services;
- **keep up with your changing customers:** update CDD information regularly given the dynamic nature of the trade cycle and the changing nature of customers' trade-related activities;
- **if in doubt, ask - there might be legitimate reasons:** consider obtaining further information where anomalies are identified. Not all anomalies necessarily mean TBML but you won't know, or be in a position to assess, until you ask; and
- **document everything:** document every step along the way, including the initial CDD process, updates, explanations, customer information and decisions (including the reasons for).

5. Transaction screening

Policies and procedures for screening and alert handling for trade-related activities are essential Trade Controls.

The key screening recommendations in the Guidance Paper include:

- applying methodologies to detect trade-based red flags, typologies, scenarios and sanctions;
- keeping sanctions, terror and high risk jurisdiction lists updated;
- performing "voyage check" and "port checks" using an RBA;
- looking out for "dual-use goods"** – a particularly complex issue;
- using manual screening to supplement automated systems; and
- handling and managing alerts appropriately.

*** The Guidance Paper defines "dual-use goods" as items that have both commercial and military or proliferation applications, making them challenging to identify and deal with in practice. While* *not exhaustive, the Import and Export (Strategic Commodities) Regulations (Cap.60G) provide some measure of assistance in relation to addressing this complex issue.*

6. Transaction monitoring

All the best AML/CTF measures are of no use if an AI does not monitor its transactions exposed to ML/TF. It is like buying an umbrella, but not checking whether it is raining.

In the same vein, AIs should establish transaction monitoring mechanisms to identify unusual or suspicious trade-based activities. This should be done with an RBA, in light of the individual AI's trade-related products and services, and with senior management oversight.

Importantly, automated systems can only do so much and should be a compliment to human effort and judgment. AIs cannot solely rely on, or outsource to, an AML/CTF "robo-cop".

7. Suspicious transaction reporting

The Guidance Paper re-iterates the importance of reporting knowledge or suspicions in a timely manner, balancing the risk of "tipping off".

Helpful guidance is provided in respect of (ideally short) internal reporting lines and processes in order to escalate suspicion to the AI's money laundering reporting officer. The key points are to consult with the relevant internal staff, assess the available information on hand and then re-assess the customer risk and adjust if appropriate.

8. Risk awareness and trade specific ML/TF training

Finally, none of the Guidance Paper's recommendations matter if the AI's staff are not aware of trade-related ML/TF risks and the AML/CTF program to combat such risks.

Key issues specific to trade-related activities and which should be communicated to staff are outlined. These include transactions and structures, typologies, emerging risks, case studies and red flags.

The appropriate staff to be trained and to act as trainers should be identified in order to direct resources as appropriately. Role-based training, in particular, is highlighted as an effective training methods for staff involved in day-to-day trade processes.

Where to from now?

The HKMA expects AIs to give full consideration to the adoption of the practices in the Guidance Paper and make improvements where needed in relation to trade-related activities. There is no “grace period” as such.

We expect to see the HKMA to continue its increasing focus on AMLO compliance and to take an increasing tougher stance. The AMLO is coming up to its 4-year anniversary in April 2016 and the honeymoon period is well and truly over.

We have been at the core of AMLO developments since the initial drafting consultation in 2009, and we continue to work with the industry as the AML/CTF regime evolves.

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