FINANCIAL CRIME COMPLIANCE CHECKS ON THE PRICE OF GOODS IN TRADE TRANSACTIONS – ARE PRICE CHECKING CONTROLS PLAUSIBLE?

POLICY STATEMENT

Key message:

1. Price Checking, beyond a common sense check for manifestly unusual pricing, is extremely challenging for Financial Institutions to carry out when processing trade documentation.
2. It is not plausible for a Financial Institution to develop a binary financial crime control for price checking and automated systems have, to date not proved to be effective.
3. Even where publically available pricing information is available (such as for commodities) price checking remains challenging due to the multiple factors which constitute the final price of the underlying commodity in a transaction.

Implementation: This paper if for industry information and guidance and designed to supplement the ICC/BAFT/Wolfsberg Trade Finance Principles.

Document review: The document will be held under watching brief of the ICC Financial Crime & Policy Group and updated as required.

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Financial Crime Compliance Checks on the Price of Goods in Trade Transactions – Are Price Checking Controls Plausible?

1. Background

1.1 Purpose
The purpose of this report is to outline the steps that would be required from an operational and risk based perspective to introduce specific price checking financial crime controls for Trade Finance transactions and, moreover, whether doing so is plausible as a measure against price manipulation. This paper will outline the various potential methods for checking the price of goods, and their feasibility, demonstrating that there are significant difficulties in implementing effective price checking.

1.2 Financial Crime Risk in Trade Finance
A number of international entities and national regulators including the Financial Action Task Force (FATF), the UK Financial Conduct Authority (FCA) and the Wolfsberg Group have all drawn attention to the misuse of Trade Finance as one of the ways that criminal organisations and terrorist financiers move money to disguise its origins and integrate it into the legitimate economy. In addition, it is recognised that the wider aspects of financial crime risks such as sanctions breaches, are also highly relevant to FIs.

FIs should aim to ensure that during the processing of trade transactions, aspects of financial crime risks are considered. This requires FIs to be in a position to know the risks, identify them, and escalate and report concerns when needed. Any decisions made should also be recorded, as well as the transaction details against which those decisions are made.

The price of goods involved in a trade finance transaction is sometimes manipulated by those wishing to launder the proceeds of crime through the financial system. Depending on the methods used, this is called either over- or under-invoicing or over- or under-supplying. As such, some regulators have suggested that a simple way to identify such activities is by banks implementing a price-check on all their Trade transactions.

1.3 Regulatory Position of Financial Crime in Trade Finance
Regulatory guidance globally suggests that price checking is an appropriate measure for financial crime prevention. To illustrate, the FCA TR13/3 report published in July 2013[1] provided analysis of UK Banks' control environments relating to financial crime risk and offered guidance on best practices in preventing it. The report referred to the checking of the price of goods in trade transactions, and stated that this was an appropriate mechanism for reducing the likelihood of financial crime remaining unnoticed during document processing. Similar guidance has also been published more recently by the ACIP (2018)[2] which states that "A bank should make reasonable effort to assess whether the price of goods in a transaction is not false, misleading or there is an obvious misstatement in price. A bank should make further enquiries where the pricing of the goods appears to be manifestly unusual and make escalations as necessary, using the established escalation protocol for TBML". This paper was endorsed by the Monetary Authority of Singapore, and the Commercial affairs Department of the Singapore Police Force.

Following the collection of bank responses that challenged the feasibility of price checking for goods in trade finance transactions, the FCA issued a statement within their Final Guidelines on the matter

1 https://www.fca.org.uk/publication/thematic-reviews/tr-13-03.pdf
2 https://abs.org.sg/docs/library/best-practices-for-countering-trade-based-money-laundering.pdf

that acknowledged the difficulty that would be faced in implementing such controls. The extract below is taken from FG14/05:

"*We acknowledge that checking the pricing of goods, underlying trade documentation and transacting parties and identifying 'dual-use' goods can be challenging for banks.*

We have always made it clear that these examples are not binding and that banks can meet their legal and regulatory obligations in other ways, but we have amended our draft to further stress the risk-sensitive nature of our guidance."[3]

Similarly, according to the UK Joint Money Laundering Steering Group, determining potential misrepresentation of value "…cannot usually be based solely on the trade documentation itself. Nor can the use of external data bases alone be relied upon as most products are not traded in public markets and have no publicly available prices. Even where such prices are available, such as those for commodities, firms will not be aware of the terms of trade, discounts involved or quality of the goods etc, so making a determination of the unit pricing will always be difficult. However, where the unit price of goods is materially different from the current market value, firms should consider whether they have a suspicion and whether they should accordingly submit an SAR to NCA"[4].

1.4 Scope

The FCA guidance did not provide specific details as to which goods it anticipated being subject to such a control. As such the investigation into the plausibility of the introduction of price checking controls has been compartmentalised into two distinct areas:

- Goods for which publicly available pricing information does not exist: Typically, this refers to value-added goods such as consumer products or items designed for a specific purpose such as industrial machinery. This category should also consider Services and/or non-physical goods such as software. There is no published and globally objective standard price for such items, and they are not listed as a tradable commodity.

- Goods for which publicly available pricing information does exist in some form: Goods such as tradable commodities for which market prices are listed within various sources (discussion on this, including Limitations, is discussed further in text).

2. Control Structure

2.1 Financial Crime Risk Indicators

It is important for FIs to implement controls to effectively manage trade-related financial crime risks. Traditionally, FIs have implemented manual 'red flag' checks which detail characteristics that are indicative of instances of financial crime, and are in line with Wolfsberg and FATF principles[5]. These red flags can be manually checked against on an individual transaction basis to identify high risk indicators within trade transactions.

To illustrate this traditional control method, various red flag related assessments can be made by the individual processing a trade transaction to confirm that this control has been completed. This

[3] FCA FG14-05 – Summary of Feedback Received (http://media.fshandbook.info/Legislation/2014/FCA_2014_34.pdf)
[4] file:///C:/Users/43846014/Downloads/Trade_finance%20(17).pdf
[5] http://www.baft.org/docs/default-source/policy-department-documents/final-clean-trade-finance-principles-final.pdf?sfvrsn=2

assessment would consider whether any specific red flags apply to the transaction at hand. Should there be an instance where any of these Red Flag conditions are met, the Trade Red Flag would be noted and the transaction would be escalated according to the FIs trade red flag escalation/review procedure.

In terms of price checking, the checker may be instructed to check if the total price of the goods in question is manifestly unusual. A manifestly unusual price can be considered as one that is outside of what can be judged to be reasonable and regular given the circumstances of the transaction and the level of information available to the checker. However, it should be noted that the checker will often lack information related to contractual agreements between buyer and seller, time of price fixing, Incoterms, relative positions of buyer and seller, or goods quality considerations, all of which influence the contract price. Additionally, document checkers or operational employees are never product specialists. As a result, a decision to escalate can only be taken in situations where price levels are manifestly different from what can be considered ‘the norm’ for such a product.

For instance, a new luxury car will not cost less than USD 1,000 or the unit price of any fresh vegetable will not exceed USD 250. As a result, experienced Trade Operations staff will generally be able to ascertain that a shipment of 100 kilograms of chili seeds should not cost USD 6 million. However, they will struggle to assess that a shipment of new luxury branded handbags should probably cost more than USD 350 apiece.

Additionally, most types of Open Account related trade transactions, have no, or only a limited, requirement for the seller to submit transactional documents containing any level of price information via the Bank. This leaves the bank with no information to assess any price levels on. Given that 80% of global trade takes place on an open account basis, with little or no information exchanged via the banking system, this makes open account type trade the most viable solution for money launderers to use.

Additional controls that may be used, utilise a combination of automated screening and post transaction AML controls. For example, a customer alert would be generated post transaction on the basis that it ‘triggered’ against certain risk indicators which resulted in the trigger threshold being met. Analysis of this customer would not only allow a sample of transactions to be assessed, but also provide the potential to identify social linkages (which may indicate a collusive network in relation to price manipulation), and analysis of other patterns in transactional behaviour such as value/volume deviation. Post transaction analysis can therefore be said to be more comprehensive and holistic. This alternative way of reviewing transactions may not be available to all FIs due to data availability and implementation costs and does not, in itself, allow price checking to be conducted, but may provide a more comprehensive risk review of potential financial crime activity.

2.2 Wider Financial Crime Compliance Policies & Procedures

Effective policies, procedures, and training are a key part of any financial crime mitigation framework to form a part of the financial crime risk controls for the customer – i.e. KYC/CDD, MI analysis, training on trends and typologies (including *why* they present risk), and procedural controls. Policy requirements can be used to define effective assignment of role and responsibility across the lines of defence, risk appetite etc. Procedural controls can include vessel checking requirements, restricting access to higher risk products or customers.

3. Considerations and Limitations

3.1 Why is price checking difficult?

In order for price checking to be practical, the attempted price manipulation should be clear, or a reliable price range should be available for the goods on any given day. However, this is only possible with the category of Commodities. For all goods, also those outside of this category, there are many variables which would need to be considered in order for price checking to be effective:

1. The date that the contract was signed;
2. The Incoterms relating to the trade;
3. The quality of the product (e.g. staple of cotton);
4. Freight costs;
5. The availability of shipping and logistics;
6. The competitive landscape;
7. Seasonality;
8. Client purchasing or selling power;
9. The actual position (i.e. long or short) of both buyer and seller at the time of price fixing.
10. The (Value at Risk) hedging policy and other financial calculations (particularly when related to commodities transactions) for both buyer and seller;
11. Prices may justifiably differ for two items classified as the same item type;
12. Role in which client is playing in the life cycle of the specific goods;
13. Relationship between client and counterparty, where a longstanding client may be given a better price related deal (where only one supplier exists for a particular product);
14. New to market products – where a benchmark price cannot be credibly established.

Although some of this information can be deduced from the trade documentation, some of the systems might not at this stage, have the capability to separate the variables (e.g. shipping terms) from the underlying price, particularly given the lack of structured documentation. Furthermore, only a few of the above variables can be deducted from the transaction. An in-depth insight in the full contract details between the parties and the way the relationship between a customer and the bank evolved is needed. This is not feasible on a transactional basis.

In addition to the above, there are other limitations that must be accounted for when deliberating the practicality of introducing a price checking control:

- The compartmentalisation and itemisation of specific goods can be extremely granular[6];
- Documentation relating to a transaction is rarely specific enough to understand the type of goods to the level of granularity required to understand which specific range should apply;
- Goods descriptions in transactions are based on the agreement between buyer and seller. There are no harmonised goods descriptions for trade transactions, nor is there a way for FIs to enforce this;
- Non-standard items, where there is unlikely to be sufficient data available to set this benchmark price;
- The availability of a usable dataset which can factor in historical pricing and trading patterns.

4. Commodities

4.1 Goods for which publicly available pricing information does exist – Commodities

[6] The *US Harmonised Tariff Schedule,* which lists over 17000 items, excluding sub-items, should be noted here as it allows Customs to conduct better price-checks than FIs are able to. This list has 17000 items categories (and many sub categories); given such granularity, the possibility of producing 'range' data on a sufficiently regular basis and in a timely manner is miniscule for FIs. http://hts.usitc.gov/

As mentioned earlier in this paper, the only category of goods for which price-checking may be possible with some semblance of effectiveness may be goods that fall into the category of Commodities. However, it should be noted that the points mentioned above will still apply to these transactions and that as such, simple screen quotes of a commodity will not be sufficient to properly assess whether a price is reasonable or not.

What methods/tools exist for understanding the price of such goods?

Multiple data providers exist for market prices according to the type of commodity for which a price is required:

- The most comprehensive source of metals prices is the London Metals Exchange[7];

- For agricultural commodities, the Chicago Board of Exchange provides comprehensive data[8];

- Subscription services exist for other commodities (e.g. *Platts* for energy and oil commodities).

It is important that a consistent source is used to provide the basis of any analysis around price. Licensed products also require subscriptions for use. Also, FIs dealing regularly with a specific commodity are likely to be in a better position to identify price manipulation than FIs which rarely see such transactions, so it is difficult to establish a common standard.

It is questionable, however, whether price checking controlled by an arbitrary range would even conceivably be possible in extremely basic commodities transactions.

4.2 Limitations to price checking for Commodities

Having defined a method for understanding which commodities may be suitable for financial crime related price checking, one must first ring-fence the population of commodities from which these are selected. In doing so the following limitations must be taken into consideration:

- Value added items cannot be subject to price checking where they are not standardly traded on the financial markets, even where the underlying good is clearly a commodity. Raw products may be used to make industry specific items (e.g. metal based industrial pipes) and it is not possible to factor in the value added.

- Commodities are often traded on the futures market. Where the price at the date of transaction is not available the price check cannot be accurately performed.

In addition to the above, it must also be taken into consideration, if performing a check, that raw materials exist in different grades. If the specific grade of the commodity is not detailed in the documentation, understanding what range is fair would be challenging. For example, the difference in price between lower grade and higher grade aluminium stands at around 15%: calculating a credible range for aluminium in general is challenging as a result.

[7] https://www.lme.com/
[8] http://www.cboe.com/

Even if market prices of certain commodities are made available by data providers (LME, Chicago, Platts), the actual price may differ from any such market prices due to the specificity of the transactions. Indeed:

- The price may include a geographical premium or discount depending of the origin of the goods (Nigerian oil sent to the US, export of Ukrainian grains for example);

- The multi-modal transport of the goods (trains, pipelines, barges) in succession

- The costs of freight may be recuperated depending of the Incoterms of the transactions (free on board[9] purchase with a cost and freight[10] resale);

- The manner in which the trader hedges certain risks (hedge on future freights) may likewise be taken in consideration while pricing.

In addition, there are commodities with no real "public" market prices available (rice, lentils).

5. Conclusion

Is analytical price checking for financial crime risk mitigation plausible?
This paper has sought to outline the various potential methods for checking the price of goods to act as a control preventing manipulation of prices of tradeable goods. The conclusion that this paper reaches is that it is not plausible for an FI to develop a binary financial crime control for price checking. Instead, mitigation is more effective to consider a wider control framework which includes manual escalation and/or post transaction analysis, as well as sound policies and procedures.

For a small number of tradable goods, publicly available pricing information is available, be it not always reliable and with a lot of variable criteria. This means that it is possible to calculate a range, however, the vast number of variables that would have to be included in that calculation nullifies the relevance of such a range. As a result, even for commodities it is not plausible to set a range as a means of introducing an analytical price range.

There is no evidence that any FI has implemented the technology required to collect individual client transactional data as to apply a bespoke formula that would allow that FI to understand if a client's transactions were technically abnormal. In order for a FI to take this approach, the FI would have to invest significantly in inventing a bespoke technology on a very significant scale, including the requirement of a wealth of historical data as well as investment in the development and testing of an appropriate algorithm. Whether this is technically possible on such a large scale is questionable, given the large number of variables that would have to be considered; such as has been established in this paper. Even if it were technically possible, it is unlikely that this would materially improve the control structure in terms of the mitigation of financial crime risk associated with trade finance transactions.

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[9] 'Free on board': there is no charge to the buyer for goods placed on board a carrier at that point of shipment.
[10] 'Cost and freight': the seller is required to arrange for the carriage of goods by sea to a port of destination and provide the buyer with the documents necessary to obtain them from the carrier.

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