Trade Misinvoicing : A common TBML typology

Introduction

Trade is the backbone of the global economy and all of us benefit from the trading of products and services around the world. Global Trade Atlas (GTA) expected the real value of global trade in both 2020 and 2021 to increase to $188,70.58 and $197,94.77 billion respectively.[1] While global trade is expanding year on year, we have observed an increasing trend in the illicit activity of criminals trying to move economic values of proceeds from their crime through global trade. The immense volume of goods traded across the international borders make it very attractive for criminals to hide behind the complexities of global trade in order to move their illicit funds and present them as the proceeds of legitimate trading activity.

There are a number of techniques that criminals use to disguise illegitimate trade e.g. over or under pricing, phantom shipments, misrepresenting the quantity/quality of underlying goods and altering the invoices to deceive banks, trading companies and the authorities. These are usually referred to as illicit financial flows (IFFs).

A report by Global Financial Integrity (GFI) defines IFFs as 'illegal movements of money or capital from one country to another'. It further classifies illicit flows as 'funds which are illegally earned, transferred, and/or utilized across an inter¬national border'. The primary sources of illicit flows include grand corruption, commercial tax evasion and transnational crime.

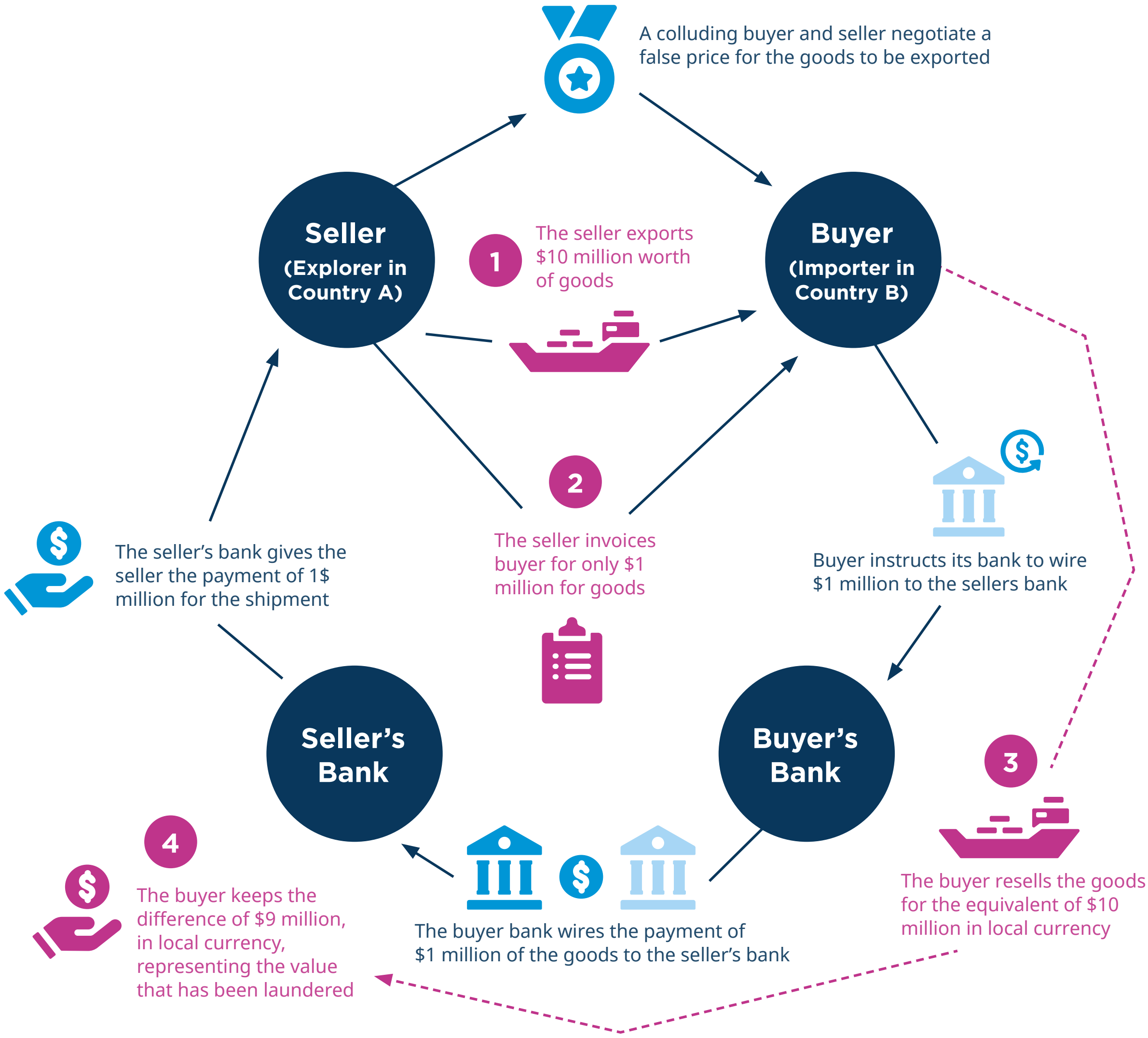
Some examples of IFFs include:

- A drug cartel using trade-based money laundering (TBML) techniques to use the illegal proceeds of narcotics sales to purchase used cars, which will be exported to the drug source country and sold;
- Trade misinvoicing by an importer seeking to evade customs duties, value-added tax (VAT), or in¬come taxes;
- A corrupt public official using an anonymous shell company to transfer stolen state assets into a bank account in another country;
- A high-net-worth individual or multinational corporation hiding taxable income or wealth from national tax authorities in offshore centres or tax havens – also known as 'secrecy jurisdictions';
- A human trafficker smuggling cash across the border; or
- An individual wiring money to finance terrorist activities in another part of the world.[2]

In March 2020, GFI issued a very comprehensive report titled *Trade-Related Illicit Financial Flows in 135 Developing Countries*[3] in which it looked at misinvoicing in particular. It utilised sophisticated data mining and filtering methodologies to identify the approximate values of misinvoiced trades, and compares data submitted by governments to the United Nations Comtrade Database every year, to perform a country trade gap analysis. Through these means, GFI found that misinvoicing is a persistent problem in developing countries, causing 'potentially massive revenue losses'. But it's not only trades between these countries that are affected. In fact, it has been found that the size of these trades is proportionately similar to trades going between developing countries and advanced economies, showing that this is a widespread issue.

A report published by the Royal United Services Institute (RUSI) highlighted that the World Trade Organization (WTO) estimated the value of global merchandise trade at nearly $18 trillion in 2017. However, less than 2% of all shipping containers are searched each year to confirm the veracity of customs invoices, providing an easily accessible channel for illicit activity. This also indicates that as the volume of global trade has increased in recent decades, the opportunities for trade misinvoicing have increased as well.[4]

It is quite challenging for financial institutions to detect over/under invoicing due to large transactional volumes, lack of trained staff, the complexity of transactions as well as the fact that only 20% of total trade transactions are carried out through bank financing, while 80% are conducted through open-account trade. The US Government Accountability Office (US GAO) published a detailed report on TBML, which was presented to the US government on 30 December 2019. GAO emphasised a number of TBML typologies including trade misinvoicing through open-account



transactions. As is evident from the above diagram, a bank normally only processes the payment when processing an open account trade transaction. However, it would not have access to a bill of lading or any other document (unless specifically requested) to understand the quantity of the underlying goods.

The limitation with an open-account trade transaction is the absence of documentation for the bank to review because the transactions are usually processed without any checks being made by the bank. At the same time, a mitigating opportunity for the bank is presented in the form of valid know your customer (KYC) checks on their client since, for an open-account trade transaction, both buyer and seller must be onboarded clients of their respective bank. It's very important for a bank to have an effective transaction monitoring control in place with realistic and accurate client profiles including transactional volumes, values, frequency, jurisdictional exposure, key products, clients and delivery channels, etc. When a bank has all of this in¬formation saved in a client profile, a well-integrated transaction monitoring system should be able to detect any deviation from pre-defined risk parameters.

It's crucial for financial institutions to be able to understand the risk associated with open-account trade transactions as well as when a bank offers the financing for a physical trade transaction. The limitation with trade finance transactions is usually the lack of information held within the bank because only the applicant of a letter of credit (buyer) needs to be the client of the issuing bank. However; the beneficiary of payment (seller) does not have to be the client of either applicant or beneficiary bank. This exposes the exporter bank to the risk of making a payment to a seller who may not be a fully on-boarded client of the bank. The limitations include not having a detailed transactional profile, information on beneficial owners and trading history. At the same time, a mitigating opportunity for both the applicant bank and the beneficiary bank is having access to trade documents e.g. bill of lading, certificate of origin of product, inspection certificate and copy of the invoice, etc. Banks must have very well-trained operations and compliance staff to be able to identify any red flags within the trade documents to mitigate the risk of over/under invoicing.

Banks as well as corporate firms involved in global trade must understand the vulnerabilities of this sector from a financial crime perspective and ensure that their staff fully understand how to identify any illicit transactions, as well as how to assess and effectively mitigate the financial crime risks through enhancing their control frameworks. ICA and Risk Screen recently published an article based on real-life case studies highlighting how criminals try to over/under invoice in order to move the value from one country to another while disguising behind legitimate trade activities.

Trade misinvoicing is a widely-used and very successful technique utilised by organised criminals. However, if the financial institutions involved in global trade business have adequately trained staff, an effective transactions monitoring system, accurate transactional profiles of their clients and access to efficient technological solutions, then the risk can be sufficiently mitigated if not fully eliminated.

References

[1] **Tomasz Brodzicki, 'Outlook for Global Trade in 2020', IHS Markit, 2 January 2020:** https://ihsmarkit.com/research-analysis/outlook-for-global-trade-in-2020.html **– accessed 1 April 2020**

[2] **Global Financial Integrity, 'Illicit Financial Flows',** https://gfintegrity.org/issue/illicit-financial-flows/ **– accessed April 2020**

[3] **Global Financial Integrity, Trade-Related Illicit Financial Flows in 135 Developing Countries: 2008-2017, 3 March 2020:** https://gfintegrity.org/report/trade-related-illicit-financial-flows-in-135-developing-countries-2008-2017/ **– accessed April 2020**

[4] **Anton Moiseienko, 'Have Your Cake and Trade It: Is it Possible to Promote Legitimate Commerce While Reducing Illicit Trade?', 1 October 2019:** https://rusi.org/commentary/have-your-cake-and-trade-it-it-possible-promote-legitimate-com¬merce-while-reducing **– accessed April 2020**

[5] **US Government Accountability Office, Countering Illicit Finance and Trade: U.S. Efforts to Combat Trade-Based Money Laundering, 30 December 2020:** https://www.gao.gov/assets/710/703609.pdf **– accessed April 2020**

[6] **ICA, InCompliance, September 2019**

[7] **Aamar Ahmad, 'Tricks of the trade',** https://www.int-comp.org/ **11 February 2020:** https://www.riskscreen.com/kyc360/article/tricks-of-the-trade/ **– accessed April 2020**