Financial crime risk controls

Price checking of goods and services in trade transactions

ICC

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Introduction and background

The misuse of trade finance to disguise the transfer of funds or value through the misrepresentation of prices of goods and services is a recognised money laundering typology with a body of discussion and guidance literature in existence on the subject.

The challenges for financial institutions (FI) in identifying such price misrepresentation have been well documented. However, it remains a risk which FI continue to be cognisant of and which regulators continue to highlight along with the need to have in place appropriate controls and identification methods. For example, as noted in the UK Prudential Regulation Authority and Financial Conduct Authority 'Dear CEO Letter' on trade finance activity, published in September 2021. The letter draws out the need to assess and understand transaction specific risks to sufficiently perform due diligence such as additional pricing checks or the use of tools such as vessel tracking and independent document verification. For any FI to perform additional pricing checks, a basic requirement would be that the invoiced price is observed to be manifestly unusual and/or other unexplained risk indicators are evident to the transaction, i.e., a risk-based approach (RBA).

Objectives

This paper provides an updated discussion on the challenges associated with the implementation of controls relating to price misrepresentation risk in trade finance transactions; the prevalent financial industry-wide approach to price checking; and the feasibility of potential price checking controls. Finally, it aims to summarise best practices and recommendations for FI engaged in trade finance, recognising that a variety of approaches hold validity based on the individual circumstances of respective institutions, and that no single solution or approach will be appropriate for all.

Scope

This paper limits itself to a discussion specific to the plausibility of price checking in trade finance, rather than the much broader topic of trade based financial crime (TBFC), where it may be noted that FI, in offering a wide range of banking products including trade finance products, would no doubt be party to payment flows which offer significantly less information than a typical trade finance transaction.

Regulatory requirements

Available regulatory guidance suggests that price checking is an appropriate measure which merits consideration by FI while also outlining associated limitations which prove this equally difficult to accomplish.

Part II Sectoral Guidance (amended July 2022): Section 15.35 of this guidance paper by the Joint Money Laundering Steering Group (2022) provides detail around inherent limitations to any approach for price checking while drawing upon the availability of market prices for the commodity sector and clear guidance that, where there is a variance to current market value in this space, FI should consider whether there are grounds for suspicion and if so, does a Suspicious Activity Report (SAR) need to be filed.

Policy Statement 470/1285: This ICC paper (2019) concludes that it is not plausible for a FI to develop a binary financial crime control for price checking. Instead, mitigation is more effective if a wider control framework is considered which includes manual escalation and/or post transaction analysis as well as sound policies and procedures.

Trade Finance Principles: Section five of this guidance paper by the Wolfsberg Group, ICC and BAFT (2019) outlines that FI generally are not able to make meaningful determinations about the legitimacy of unit pricing due to the lack of relevant business information, such as the terms of a business relationship, volume discounting or the specific quality of the goods involved. Further, many products are not traded in public markets and there are no publicly available market prices. Even where goods are publicly traded, the current prices may not reflect the agreed price used in any contract of sale or purchase. These details will not usually be available to the FI involved due to the competitive sensitivity of such information. Any RBA should involve guidance and regular training for staff to raise awareness around how to perform an analysis of pricing for those goods where reliable and up-to-date pricing information can be obtained, how to identify where a unit price would be seen as obviously unusual and the escalation process that should be followed.

Trade Based Money Laundering Risk Indicators: The guidance paper by FATF (2021) states that some of the risk indicators (RI) require the cross-comparison of various data elements (e.g., financial transactions, customs data and open market prices) often held in external sources. These RI relate to consistently low profit margins, inconsistencies in prices between documents and inconsistencies with market value. Due to this reliance on external data, the private sector will not observe all the RI outlined by FATF. For some of the RI, the private sector will need additional contextual information from competent authorities, e.g., via engagement with law enforcement authorities or financial intelligence units. In using these indicators, private sector entities should also take into consideration the totality of the customer profile, including information obtained from the customer during the due diligence process, trade financing methods involved in the transactions and other relevant contextual risk factors. The guidance further states with respect to the RI on consistently low profit margins that determining the profit margin may require estimating the "fair price" of the traded commodity, which might be difficult for certain types of commodities, e.g., commodities not traded on the open market.

Challenges associated with price checking

Lack of reliable price reference points

The absence of a universally applicable reference point is an accepted gap for any viable price checking control. There is no evidence that any FI or other entity (regulatory or otherwise) has implemented the technology necessary to collect transactional data at the customer level across FI globally to understand if the invoice price for any trade transaction is abnormal.

Legitimate reasons supporting price variations

Several influencing factors dictate pricing across suppliers, markets, countries, regions and products. Some of these commonly known factors are as follows:

a) Time (the date on which any contractual obligation to buy/sell was entered; the price applicable at this point of time; the price applicable as of the time the goods/services

exchanged hands; extenuating factors driving price volatility between these periods; the resources available to FI to determine these variations as at the time of transaction processing; currency exchange volatility; futures and forwards; hedging; etc)

b) Trade Incoterms (costs associated with the commercial exchange of goods including the cost of freight and/or insurance; factors impacting ease of shipment; distance; logistics; customised shipping needs; perishability; seasonality; conflict and how these factors impact the costs of freight and/or insurance and consequently price; etc)

c) Quality and product nuances (mapping variances in the quality of goods of the same type to value requires commercial expertise relative to the respective goods, which is not in scope for trade finance professionals; value addition processes; integral vs aesthetic/customised requirements; luxury goods; premium valuations of customised goods/restricted volume production; standard rebates for surplus stock/near expiry stock; repeat orders of discontinued goods; upgrade offers for newer models/latest updates to held stock; etc)

d) Purchasing power vs selling power across complimenting industries; markets; countries and regions (demand/supply mechanics and how these influence the price at which goods are traded; role played by trading entities in the lifecycle of a product from design to sourcing to market; etc)

Approaches to price checking

Manual review/escalation by processing staff

(a) By and large, the most prevalent approach to price checking continues to rely on the human element, i.e., a subjective judgmental call taken by transaction processing staff to determine if the invoiced price is manifestly unusual or not. This draws from readily available knowledge that staff might reasonably hope to gain over time. For example, manifestly unusual pricing might be easily determined for footwear or household consumables as compared to the price for niche plant machinery of a very detailed technical configuration which would lean towards there being a requirement for a different means of price evaluation. Any such complex valuation borders on research capabilities which are not within the remit of FI engaging in trade finance. It is also accepted that it is not possible to arrive at a plausible price range for services based on the indeterminate levels of quality for any service provided.

(b) Any such manual approach could be coupled with price checking for commodities which are traded on the financial markets and for which prices are available to a reasonable degree of accuracy. However, it must be considered that reliable pricing might not be available for commodities traded on the open market due to the value addition process through trade in intermediary goods which make up commodities (for which market led pricing is available or not) and the varying qualities inherent to all commodities in consideration. Price checking is clearly achievable only for a few select commodities which are primarily split between energy and non-energy commodities (The World Bank 2022). Energy commodities are further split into 10 commodity types across coal, crude oil, natural gas and liquified natural gas. Non-energy commodities are split across five main categories (agriculture, raw materials, fertilisers, metals and minerals and precious metals) which are sub-divided across 58 individual commodities. In comparison, in its Harmonised Tariff Schedule the US International Trade Commission (2022) lists over 17,000 items, excluding sub-items, making it abundantly clear that any focus on price checking for commodities would arguably address the risk of price misrepresentation for a miniscule percentage of goods/services associated with trade finance activity.

(c) The use of historical transaction data is significantly limited as the exhaustive goods description including quality, packing, weights, quantities, unit process, associated freight costs, insurance costs, container counts, etc. are seldom input to transaction operating platforms. The ability to use historical transaction data is therefore directly correlated to the volume of data input for processing trade transactions. In most instances, the impact outweighs any accruable benefit due to the sheer scale of trade transactions processed by FI. Another limitation would rest with any historic data being solely pertinent to the FI employing such an approach and as such would potentially include poor data when working to arrive at an average price for a certain type of goods/services across customers. It may, however, be fair to understand that historical representations might be made with respect to the customer's standing with the FI, i.e., track record.

(d) Depending on a FI's RBA and its risk appetite, enhanced due diligence (EDD) may require to be undertaken where the countries, products or customers involved are deemed to be high risk, or where the goods are deemed being high risk due to the potential of price manipulation or dual-use goods (DUG)[1] by nature. This might include a process where customer due diligence (CDD) is assessed to understand whether they trade in high-risk goods and potentially requiring enhanced monitoring.

Specialist teams

Any approach towards arriving at a fair market price for goods and services which goes beyond a common-sense check to ascertain if the invoiced price is manifestly unusual or not will effectively require the creation of a specialist team dedicated to the task of ratifying fair market price. Aside from being extremely expensive, the efficacy of a specialist team would still be impacted by the inherent limitations to price checking which are pertinent to the financial industry. As part of any RBA, FI could implement procedural guidance which pivots around a single or a few key risk indicators to trigger a requirement to perform price checking for certain high-risk transactions rather than for all transactions.

Automated identification of collusion risk

Collusion is seen as instrumental for price misrepresentation and typically manifests through common ownership between buying and selling entities. From a CDD perspective, the customer is owned by the business line and the products/services offered to the customers will be managed by separate functions within the FI. Even if the counterparty were to be banked by the same FI in another country, the CDD information held for each customer cannot be shared across borders due to data sharing restrictions. It is impractical to expect trade finance staff to be familiar with the concepts of key officials, partners, directors, sole authorised signatory, authorised representative, ultimate beneficial owner, key controllers, etc., any one or more of whom might be the common link in any shared ownership between the customer and counterparty. Furthermore, while CDD information for the customer would be available internally to the FI, there would be no data available on the counterparties (unless the counterparty is another customer of the same FI

[1] According to the Joint Money Laundering Steering Group (2022), dual-use goods are items that have both commercial and military or proliferation applications. This can include goods that are components of a weapon, or those that would be used in the manufacture of a weapon (e.g., certain machine tools that are used for repairing automobiles can also be used to manufacture certain component parts of missiles).

in the same country). However, consideration may be given to the development of post-transaction automated monitoring solutions using social network analytics and big data techniques to identify such common ownership structures, whether known or undisclosed to the FI.

Automated detection through emerging technology

Certain technologies have been developed by third party vendors for use by FI and by FI themselves. These automated solutions are positioned as potential solutions to the challenge in identifying not only DUG but also broader TBFC concerns including pricing anomalies. The significant cost associated with the implementation and use of these technologies makes it a challenge for smaller FI to adopt these solutions.

At present, technological solutions remain applicable at the post transactional stage unless FI were to create a bridge between live operating transaction platforms and third-party solutions or were otherwise able to develop this technology in-house. A typical technology solution incorporates automation relative to the extraction of goods description from documents; standardisation through conversion to universally applicable goods classification (HS codes); screening against regulatory prescribed lists of dual-use goods (where available); market price analytics; validation against maritime intelligence; and comparison across trade data available as subscription only services by aggregators; etc.

Any such solution would aim to isolate specific higher risk cases requiring in-depth review, i.e., the generation of alerts/events which are escalated to specialist teams created for the purpose of ratifying unusual pricing to isolate instances which merit SAR filing. However, none of these solutions have shown significant levels of success across many financial institutions and only serve to generate an unmanageable number of alerts with a false positive rate greater than 99%. A major impediment towards progress in this sphere of development relates to the standardisation of goods through a data feed rather than from the physical paper invoices (data input standards/limitations); the probability that the goods descriptions available to FI may or may not factually represent the complete goods description; and the absence of HS codes in transaction documentation available to FI.

Recommendations and best practices

Notwithstanding the challenges and limitations, FI may adopt a manual review of trade finance transactions (where the relevant documents are present) to assess the validity of the transaction which could include price checking (generally performed using an RBA involving the detection of manifestly unusual pricing and other RI to trigger a check on the invoice price). Price checking for commodities is considered to have a reasonable degree of accuracy against a backdrop of inherent limitations but this is clearly achievable only for a select few commodities for which published market prices exist. Contingent to scale and scope of operations, FI may also consider engaging with third-party vendors to explore the use of emerging technologies aimed towards the automated detection of higher risk patterns visible through implied collusion between socially connected entities as also other risk indicators which are difficult to detect via a transaction level RBA.

Conclusions

This paper focuses on the challenges associated with the implementation of controls relating to price misrepresentation risk in trade finance transactions. However, this is only one consideration as to the validity of a transaction and whether other risks occur needs to be assessed. Price checking in isolation is not currently an effective control to identify trade-based money laundering through price manipulation and firms should take a broader holistic approach to understanding customers' activities.

The paper concludes that it is not achievable for FI to implement a binary price checking control which relies on information contained within the documents of a single transaction. The industry practice of relying on an assessment to identify manifestly unusual pricing supported by a sample-base or trigger-based pricing review process for commodities traded on the financial markets continues to have support across the financial industry. There is a clear desire for technology solutions to assist with the mitigation of financial risk within the financial services industry with some vendors having a focus on price checking. However, the challenges outlined in this paper still exist.

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