


RISKY BUSINESS

THE SANCTIONS CHALLENGES OF TRADE FINANCE



As governments across the globe, including the EU, US, Canada, UK, Japan, Singapore and more, have imposed sanctions on Russia, with promises of additional action if Russia persists with its war on Ukraine, financial institutions and their customers are forced to review their trade and commodities transactions involving Russia to assess their legal and reputation risk. These reviews are complicated by the number and complexity of the sanctions and trade restrictions already imposed, and by concerns about what might come next.

WHITE PAPER

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BACKGROUND

Much has been written about the heightened financial crimes risk of trade finance, and the expectations of the financial services industry for managing these risks while it continues to support international commerce and free trade. The industry is all too aware of the potential consequences that may stem from violations of their legal and regulatory requirements, including regulatory enforcement actions, civil and criminal fines, and even the risk of incarceration.

Financial crimes risks for trade finance include:

- Money laundering (in many forms).
- Violations of sanctions, trade embargoes, dual-use restrictions and anti-boycott measures, as well as the failure to prevent the proliferation of nuclear, chemical and biological weapons and their means of delivery.

What complicates financial crimes risk management for trade finance are the number of parties involved in a trade transaction – buyers, sellers, banks (in a variety of roles), shippers, freight forwarders, storage providers and insurers, to name a few – and trade documentation practices, many of which are highly manual and cannot be easily automated. Both of these factors contribute to the challenges of sanctions screening and transaction monitoring.

In addition to publications from the Financial Action Task Force (FATF) and the Egmont Group, one of the most authoritative publications on this topic is The Wolfsberg Group, ICC and BAFT Trade Finance Principles (2019 Amendment), which outlines the control measures and escalation procedures that financial institutions should consider to manage trade finance financial crimes-related risks. This publication should be required reading for all financial institution employees involved with trade finance activities. We leverage some of the guidance included in this publication in our discussion below.

IMPACT OF RUSSIAN SANCTIONS ON TRADE FINANCE

For the purposes of this paper, our focus is on compliance with sanctions and trade restrictions, specifically compliance with the Russian sanctions. As we have explained in prior Protiviti publications, “10 Actions Financial Institutions Should Take to

Address the Russian and Belarussian Sanctions” and “More Than Just Sanctions: How Financial Institutions Are Impacted by the Russian-Belarusian Sanctions”, the Russian sanctions pose added risk to the financial services industry because of their breadth; their complexity; the speed at which they have been rolled out, often with limited implementation guidance; and the fact that Russia, prior to its invasion of Ukraine, was a top 10 global economy and thus intertwined with both the East and the West, e. g. Russia’s top 10 trading partners in 2021 were:

1. CHINA
2. GERMANY
3. NETHERLANDS
4. BELARUS
5. UNITED STATES
6. TURKEY
7. ITALY
8. SOUTH KOREA
9. UNITED KINGDOM
10. KAZAKHSTAN

Russia’s main imports have been cars, vehicle parts, broadcasting equipment, packaged medicines and computers.¹ In 2020, Russia was also the world’s biggest importer of aluminium oxide, precipitated copper, refractory cements, wallpaper, and hydraulic turbines. Russia’s top exports have been crude petroleum, refined petroleum, petroleum, gold, and coal briquettes.² Russia has also been the largest exporting country of wheat.³

Given the rapidly changing environment relating to Russian sanctions and trade restrictions, financial institutions should consult with counsel on the most recent developments and applicability of the requirements. By way of background, however, the trade restrictions (which vary by jurisdiction) imposed so far have involved, but are not limited to:

- A comprehensive trade embargo on the self-proclaimed Donetsk and Luhansk People’s Republics.
- Prohibitions on the export of goods that contribute to the military and technological enhancement of Russia, or to the development of the Russian defence and security sector; goods that are used in petroleum refining; and goods that are used in the aerospace industry.
- Restrictions on the export of luxury goods to Russia.
- Winding down of imports of Russian oil and natural gas.

→ Various restrictions on the import of Russian commodities and goods, including steel, fish/seafood, alcohol and non-industrial diamonds. Some jurisdictions, including the US, UK and EU, have also taken steps to remove Russia's Most Favoured Trade status, which has major tariff implications.

Settling of trade transactions has been impacted by sanctions placed on the Central Bank of Russia and many major banking organisations, as well as by the exclusion of many Russian banks from the SWIFT settlement system.

SHORT-TERM ACTIONS FOR MANAGING TRADE FINANCE-RELATED RUSSIAN SANCTIONS RISK

Effectively managing this dynamic and complex environment will significantly challenge many financial institutions. There are actions financial institutions should take now to address this challenge.

01 REASSESS RISK STRATEGY/RISK APPETITE

The board of directors and executive management will need to quickly reassess the institution's risk strategy and risk appetite related to managing the differences among the sanctions and trade restrictions issued by various institutions, and the attendant business and reputation risks. Risk strategy and risk appetite may evolve over time, but the rest of the institution needs immediate guidance to shape its response.

02 FORM A PROJECT TEAM WITH REPRESENTATIVES FROM ALL RESPONSIBLE DEPARTMENTS AND DISCIPLINES

The trade finance department, trade operations (including trade document subject-matter experts), trade processing and wire transfer operations, legal, and compliance will all need to be involved in the management of Russian sanctions and trade restrictions, and will need to have a common understanding of the requirements and the institution's risk appetite. Therefore, the first order of business – which we expect many institutions have already undertaken – is to form a project team of these and other key representatives. The project team should develop a plan for addressing the sanctions and trade restrictions which details the project tasks; assigns clear responsibility and accountability; sets timelines for the actions that need to be taken; and establishes protocols

for status reporting, which can be used to keep executive management and the board of directors informed of this important effort. The project team should also establish and communicate escalation procedures for interpreting and deciding sanction and trade restriction requirements, and questions related to the institution's risk appetite.

03 KEEP ALL RESPONSIBLE PARTIES INFORMED OF THE SANCTIONS AND TRADE RESTRICTIONS

In most institutions, in-house and/or external counsel will be responsible for identifying and determining applicability of the sanctions and trade restrictions. In collaboration with these legal advisers, others in the institution, such as training departments or compliance, will need to develop

EXAMPLES OF TRADE TRANSACTION EVALUATION CRITERIA

- Originator, beneficiary and end-user if not the beneficiary
- Goods involved
- How the goods can be used, e. g. for a dual-use or other prohibited purpose
- Value of the goods and how it was validated
- How the goods are being transported, e. g. name and ownership of vessel
- Other parties involved, e. g. name, ownership, location of freight forwarders, storage facilities
- Origin, destination and all intermediary points of the transportation journey
- Buyer and seller (the size and nature of their businesses relative to the transaction, their reputations, controlling parties, beneficial owners, etc.) and their relationship
- Export permits, exporter declaration and other relevant documentation
- Banks involved with the transaction and their roles
- Method and currency of settlement
- Document discrepancies or unexpected documentary changes

» It is important for institutions to have a defined and documented process to deal with inadvertent breaches of sanctions and trade restrictions.«

CORNELIA TOMCZAK, DIRECTOR



effective and real-time methods for keeping all parties informed of developments. These methods might include an information hub on the institution's intranet and a sanctions/trade compliance hotline. Individuals with hands-on compliance responsibilities should be provided with targeted training and access to external resources that may help them, such as internally developed FAQs and FAQs published by some of the sanctioning bodies such as OFAC and the EU. Institutions should also consider holding at least daily meetings/calls for those with hands-on responsibilities to communicate changes and establish priorities.

04 IDENTIFY OUTSTANDING TRADE FINANCE TRANSACTIONS AT RISK

Institutions will need to quickly identify all trade transactions involving Russia, Donetsk and Luhansk, and triage these transactions to determine which may now be subject to sanctions and trade restrictions, which require additional analysis, and which remain permissible. For those transactions no longer permissible, institutions

will need to determine next steps. This exercise will require rescreening transaction parties that were previously subject to manual screening (a process that will need to be repeated and expanded upon as restrictions continue to be added) and conducting additional due diligence on parties to the trade, which themselves may be sanctioned or owned by sanctioned parties. These decisions will need to be made with the advice of legal counsel and in accordance with the institution's escalation procedures. The rationale for all decisions and resulting action plans should be documented with evidence of required internal approvals.

05 IDENTIFY SETTLEMENT RISK EXPOSURE

Financial institutions will need to identify and quantify settlement risk related to outstanding trade activities. These risks may arise because the trade activity is now prohibited or because trade parties no longer have access to the channels that would have been used to settle the transaction, e. g. a trade party's bank has been sanctioned and/or no longer has access to the SWIFT messaging network. Alternative messaging networks may include the messaging system developed by the Russian Central Bank, the System for Transfer of Financial Messages (SPFS), or China's CIPS settlement platform, both of which have limitations. As such, settlements may be effected through less efficient, higher touch bilateral arrangements using phones, faxes or messaging apps that may involve the use of intermediaries to facilitate payments. An important part of this exercise should include identifying and communicating "red flags" for pinpointing attempts to evade sanctions and trade restrictions.

06 EXPECT INADVERTENT BREACHES

Financial institutions rarely, if ever, plan for violations of law. But the reality of the current situation suggests that inadvertent breaches of sanctions and trade restrictions will occur in many institutions. It is important for institutions to have a defined and documented process to deal with these breaches, which includes documenting the rationale for the action that was taken, identifying lessons learned, and taking steps to prevent recurrence. This documentation, along with the steps outlined above, will be necessary for an institution to challenge the suggestion by a regulator or other stakeholder that it failed to make a good faith effort to comply with the applicable requirements.

The task is daunting, but the worst course of action is inaction, and the risks of inaction are significant.

ABOUT PROTIVITI'S FINANCIAL CRIMES PRACTICE

Protiviti's Financial Crimes practice specialises in helping financial institutions satisfy their regulatory obligations and reduce their financial crime exposure using a combination of AML/CTF and sanctions risk assessment, control enhancements, and change capability to deliver effective operational risk and compliance frameworks. Our team of specialists assists organisations with protecting their brand and reputation by proactively advising on their vulnerability to financial crime, fraud and corruption, professional misconduct, and other financial business risk issues.

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SOURCES

[1] *Observatory of Economic Complexity (OEC), Trade, Complexity and Rankings Updated to 2020.*

[2] *Idem*

[3] *Idem*

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