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1 | KEY FINDINGS

1.1 THE IMPORTANCE OF TRADE FINANCE

Over the last two decades, the average share of exports and imports of goods and commercial services in world GDP increased significantly from 20% in 1995 to 30% in 2014, despite the negative effects of the financial crisis. The World Trade Organisation notes that total merchandise trade now exceeds USD 18 trillion. The financial services sector plays a major role in this growth. On average, trade associated with the financial services sector has grown 11% annually, between 1995 and 2014, the second highest commercial services sector after computer and information services¹.

At a local level, Dubai Trade reported² a 6% increase in UAE foreign trade to USD 263 billion in the first three quarters of 2015. This figure is projected to increase to USD 354 billion in 2016. In addition, the Dubai 2021³ Plan aims to enhance Dubai's standing as a global business centre to be among the top five centres for trade, logistics, finance and tourism. Trade has historically been, and continues to be, a significant element in Dubai's economic profile.

The growth in trade finance activity in the Dubai International Financial Centre⁴ ("DIFC or the Centre")

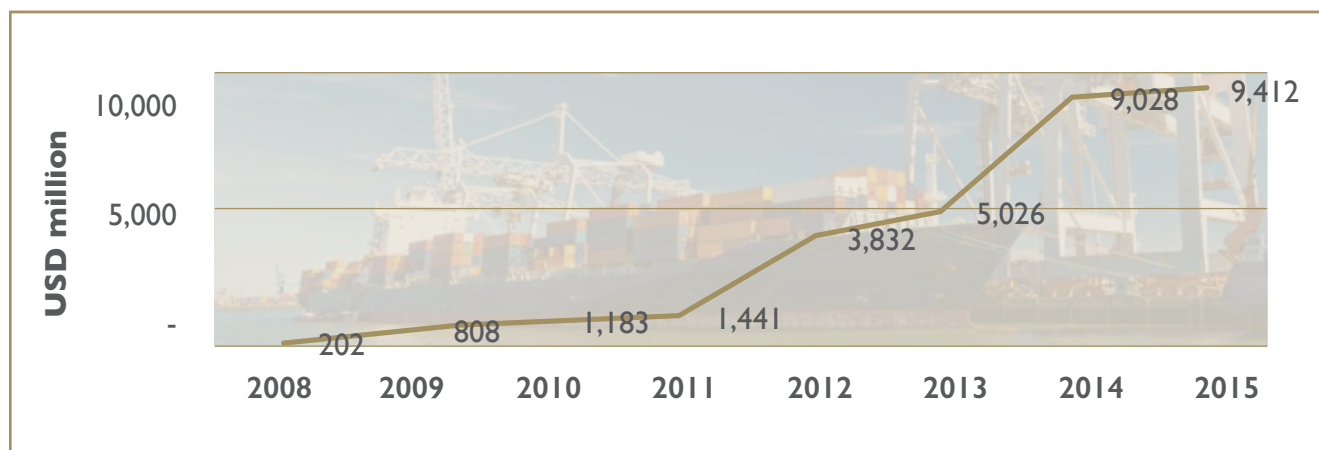
has been steady over the past seven years, but momentum has increased significantly since 2011, as can be observed in Chart 1⁵.

This trend is consistent with the general growth of activities registered in the Centre over the same period.

In its support for the Dubai 2021 plan, in June 2015 the DIFC also announced its 2024 strategy, which includes growing the size of the Centre by three-fold. The DIFC estimates 50% of its overall future growth to come from its strategic access to the Middle East, North Africa and South Asia (MENASA) region, which possesses a combined GDP of USD 7.9 trillion. The Centre places special focus on improving integration between Asian and Middle Eastern financial institutions to upgrade regional trade and project finance.

The most common goods financed by Firms⁶ are commodities: crude oil, oil products, gas, soft commodities and automobiles (cars/spare parts). Other notable items were precious metals and jewellery related products. The type of trade finance activity in the DIFC covers a full range of trade finance products.

Chart 1 Trade Finance Assets (on and off balance sheet)



1 International Trade Statistics 2015. World Trade and the WTO 1995 - 2014 key developments (https://www.wto.org/english/res_e/statis_e/its2015_e/its15_highlights_e.pdf)

2 This is a direct quote from the CEO of Dubai Trade, Eng. Mahmood Al Bastaki.

3 <http://www.dubaipplan2021.ae/dubai-plan-2021/>

4 The DIFC is a purpose-built financial free zone in Dubai, UAE.

5 The chart provides a snap shot of trade finance activity at the end of Q4 2015. Since Trade Finance business is generally short dated, the chart is indicative only of Trade Finance deals booked in the DIFC at that time. It does not show the total volume of Trade Finance business managed by Firms in the DIFC.

6 For the purposes of this report, Firms include DFSA Authorised Firms.

1.2 REGULATORY CONCERNS

The Financial Action Task Force (“FATF”), the Wolfsberg Group and the Joint Money Laundering Steering Group (“JMLSG”) have all drawn attention to the vulnerabilities of international trade to money laundering, terrorist financing and sanction breaches, otherwise called Trade-Based Money Laundering or TBML⁷.

FATF recognises trade finance as being one of the three main methods used for money laundering. The reports from FATF, Wolfsberg and JMLSG noted that the TBML methods varied in typology from the most basic, such as over- and under-invoicing or double invoicing, to very complex schemes.

TBML has also received increasing attention from regulators globally. Comprehensive reports and guidance papers have been published by bodies including the UK Financial Conduct Authority⁸ (“FCA”), Monetary Authority of Singapore⁹ (“MAS”) and Hong Kong Association of Banks¹⁰ (“HKAB”) on money laundering controls surrounding trade finance.

1.2 THE DFSA'S ROLE

Given the importance of trade finance to the economy and to the future success of the DIFC, the Dubai Financial Services Authority¹¹ (“DFSA”) has an important role to ensure this activity is conducted safely and in a manner that properly manages and mitigates the risk of TBML and financial crime. Whilst we fully support the role that trade finance has in the DIFC, we recognise that such activities come with higher TBML and reputational risks that need to be carefully managed by Firms. As part of this effort, we launched a trade finance related thematic review in 2015 (“the Review”). The Review aimed to assess the quality of systems and controls being utilised by Firms to conduct trade finance activities in or from the DIFC and particularly to mitigate TBML risks.

1.3 OUR REPORT

This report highlights the DFSA’s findings in the Review alongside its general observations in relation to the measures Firms undertook to manage risks and comply with DFSA Rules.

We believe that the outcome of our Review contains important lessons that all Firms engaged in this activity in or from the DIFC should take on board. We strongly encourage Firms to use this report to benchmark their own systems and controls and make any necessary enhancements.

Our Review started with a questionnaire sent to more than 300 Firms¹², together with a series of on-site visits to 17 of these Firms. At the time of the Review, there were 26 banks¹³ engaged in trade finance and we visited nearly half of them. As such, the majority of our findings relate to these banks and, therefore, the better practices listed in Appendix A of this report will generally apply to those Firms. Nevertheless, we also encourage all other Firms to assess all practices listed and incorporate those practices that apply in their own systems and controls.

The main caveat to this report is the sample size of the on-site inspections. The sample size was not sufficiently large enough to draw accurate conclusions as to the level of compliance across all Firms in the DIFC and therefore, the results should be viewed as indicative only and not representative of practices across all Firms in the Centre.

In this report, unless otherwise identified, an acronym or term with the first letter capitalised has the meaning given to it in the Glossary Module of the DFSA Rulebook (“GLO”).

1.4 GENERAL OBSERVATIONS

During the Review, we noted several areas of potential improvement. In particular, we noted improvement

⁷ For the purposes of this report, breaches of the Anti-Money Laundering (AML), Counter-Terrorist Financing (CTF) and sanctions obligations are collectively referred to as Trade Based Money Laundering (“TBML”). TBML has been defined by FATF as being the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimise their illicit origins.

⁸ TRI13/3 - Banks' control of financial crime risks in trade finance, FCA, July 2013.

⁹ MAS Information Paper, Guidance on anti-money laundering and countering the financing of terrorism controls in trade finance and correspondent banking, Monetary Authority of Singapore, October 2015.

¹⁰ Guidance Paper on Combating Trade-based Money Laundering, The Hong Kong Association of Banks, 1 February 2016

¹¹ The DFSA is the independent regulator of financial services conducted in or from the DIFC.

¹² Covering PIB Categories 1 – 5, excluding insurance Firms (PIN Firms). Overall, we had 278 responders; a response rate of 89%. Based on the questionnaire data received on 17 September 2015, 56 Firms reported having activities with some connection to Trade Finance. Of those Firms, approximately 48% book these activities on their balance sheets.

¹³ For the purpose of this report, PIB Category 1 Firms are referred to as banks. For the descriptions of the PIB categories, refer to the table in A1.1 of Appendix 1 in the PIB Module of the DFSA Rulebook.

opportunities in general awareness of trade finance risks. An inadequate focus on the specific financial crime risks associated with trade has had a negative impact across several system and control elements included in the Review, namely: governance, risk assessment, customer on-boarding and on-going Customer Due Diligence (CDD). Firms are required to have a certain level of awareness regarding TBML risks prior to designing effective risk-based controls to manage them. On the whole, many of our findings are consistent with the reviews undertaken by other international regulators and the guidance they have contributed to this growing area. We would urge Firms to avail themselves to all international guidance issued to enhance the management of TBML risks.

1.5 BUSINESS MODEL AND GOVERNANCE

Overall, outsourcing is the main concern we have with regards to Firms' business models and governance frameworks. This is particularly vital for banks that carry out transaction monitoring via their Groups. We note that in some cases banks are not able to explain the functions that are being outsourced to other processing centres and/or Groups. Whilst Firms generally demonstrate oversight of credit risks and internal controls for trade finance related business, they do not demonstrate a similar level of emphasis for TBML risks.

1.6 SKILLS, KNOWLEDGE AND EXPERIENCE

Training lacks specific and tailored information detailing relevant "Red Flags"¹⁴, discussing real case studies and ensuring that staff can apply the training on the job. Furthermore, greater emphasis needs to be placed on recruitment procedures in order to ensure that staff with appropriate skills, knowledge and experience are recruited either internally from within the Group, or externally. Trade finance risks are highly specialised, thus Compliance Officers and other relevant staff need specialised skills to understand these risks.

“CREDIT RISK IS BEING EMPHASISED AND PRIORITISED WITH LESS FOCUS ON TBML RISKS”

1.7 MONEY LAUNDERING RISK ASSESSMENT

1.7.1 AML BUSINESS RISK ASSESSMENT

In general, Firms are not undertaking a meaningful review of their trade finance related activities in order to identify specific TBML risks they are exposed to because of the nature of their business. The widely different practices in this area also suggest that there is a poor understanding generally about the objectives of the AML Business Risk Assessment.¹⁵

1.7.2 CUSTOMER RISK ASSESSMENT

The methodologies associated with AML risk scoring of customers are not sufficiently sensitive to trade finance products and risk indicators. There is a general theme running throughout the findings of our Review where credit risk is being emphasised and prioritised with less focus on TBML risks.

1.8 ON-BOARDING CDD AND ON-GOING CDD

Overall, we are concerned that Firms are not effectively implementing risk-based processes that consistently monitor for higher risk transactions. Almost all Firms have room to improve their systems and controls to enable them to perform appropriate and effective on-going CDD and transaction monitoring. In particular, controls around identifying and dealing with the risk of dual use goods need improvement.

¹⁴ Red Flags are methods or indicators used by relevant parties to a Trade Finance transaction to advance TBML, including financial crime. Comprehensive reports and guidance papers have been published by FATF, Wolfsberg, FCA, MAS and HKAB highlighting typical types of Red Flags.

¹⁵ Refer to Chapter 5 of the AML Module of the DFSA Rulebook. For further guidance, refer to the report published by Wolfsberg on risk assessments: <http://wolfsberg-principles.com/pdf/home/Wolfsberg-Risk-Assessment-FAQs-2015.pdf>

Whilst Firms are doing a better job at the initial on-boarding CDD stage, they should assess what information must be captured during this stage in order to effectively monitor customers' transactions going forward. This is particularly relevant when monitoring for higher risk transactions pertaining to customers' behaviour, deal structures and goods.

Where Firms are monitoring customer transactions for Red Flag alerts, there is a general over-reliance on employee experience which is not always relevant and extensive enough to cover all types of transactions and goods. Firms tend to place a greater emphasis on their controls for managing sanction breaches rather than AML breaches, although improvements to systems and controls are still required in this area.

1.9 FINAL COMMENTS

We would like to thank all Firms who participated in this Review, either by taking part in completing the questionnaire or the on-site assessments. Also, we would like to thank the Firms who have shared valuable knowledge and expertise with the DFSA and assisted with preparing for the Review.

2 | BUSINESS MODEL AND GOVERNANCE

2.1 BUSINESS MODEL

Given that business activities in the DIFC are broadly wholesale in nature, the target customers of the Firms we visited were Market Counterparties and Professional Clients. These included financial institutions, corporates and commodity traders.

In terms of the banks we reviewed, we noted that some were Arranging¹⁶ in respect of trade finance transactions to other parts of their Group. In these scenarios, we noted that some Firms failed to on-board and recognise them as customers of the DIFC branch¹⁷. Firms need to ensure that these customers are adequately on-boarded. Should Firms then want to rely on Group entities to carry out relevant due diligence, they may

do so in accordance with AML Rule 8.1. Firms need to take adequate steps to ensure that relevant policies and procedures are equivalent to the ones applied in the DIFC and conduct checks to ensure they are effectively implemented.

Given that most banks in the DIFC are smaller in nature compared to their head office and banks located in other larger jurisdictions, some functions are being outsourced to other parts of the Group. We observed an overall lack of appropriate oversight of Firms outsourcing these functions¹⁸. This is particularly important for banks that carry out transaction monitoring via their Groups outside of the DIFC. We note in some cases that banks are unable to explain how the functions being outsourced to other processing centres and/or the Group are carried out. Overall, the common themes include:

- Incomplete awareness of the end-to-end processes, systems and controls;
- Inadequate oversight of key control elements of processes done in other parts of the Group or lack of a risk-based approach for justifying reliance upon work done by other departments; and
- A fragmented understanding of customers. Firms are not fully harnessing information held about customers in other departments in order to undertake effective monitoring of its customers' trade finance related activity.

For further information refer to Section 5.2.5, "Inter-departmental processing of trade finance transactions."

2.2 GOVERNANCE

2.2.1 THE ROLE OF SENIOR MANAGEMENT

The role of senior management in relation to managing TBML risks generally includes sign-off responsibilities as well as a point to which AML issues are escalated, particularly at the customer on-boarding stage. In some Firms, the SEO and Head of trade finance review and sign-off on all customers on-boarded. However, it is

¹⁶ Arranging Credit or Deals in Investments as defined in the DFSA's General (GEN) module.

¹⁷ As prescribed in the DFSA's COB and AML Rulebooks.

¹⁸ As prescribed in GEN Rule 5.3.21 and AML Rule 8.2.

evident that such reviews are credit risk driven, without considering TBML risks specifically. In the relatively larger Firms operating in the DIFC, senior management have a more limited role in this respect.

Ordinarily, having senior management sign off on all trade finance transactions may be appropriate given the nature, scale, complexity and maturity of activities, however, senior management need to ensure that the level of oversight provided remains effective and that the overall quality of reviews undertaken are not compromised.

Senior management places high emphasis on an employee's adherence with existing procedures rather than the adequacy of these procedures in the context of TBML. The DFSA considers that a significant influence on a Firm's compliance culture is set by senior management who is ultimately responsible for compliance with the Firm's regulatory obligations.

2.2.2 MANAGEMENT INFORMATION

Management information for trade finance related business for most Firms generally does not include TBML related risks, other than the mandatory obligations imposed by the DFSA (i.e. having an "AML Business Risk Assessment" and the submission of "Annual AML Returns"). Some Firms did escalate AML issues to senior management where and when appropriate, such as suspicions of financial crime. However, we found limited evidence of Firms regularly reporting to senior management with the objective of providing a beneficial view of how TBML risks are evolving in its trade finance business. This may, in part, be due to the significant involvement of senior management on a day-to-day basis in its business activities (see Section 2.2.1 above) on a customer and transactional basis.

2.2.3 THE ROLE OF INTERNAL COMMITTEES

Almost all Firms identified the credit committee as being the main forum where TBML risks and issues may be discussed. Some Firms have more specific forums reviewing TBML concerns; however, this is rare and mainly specific to the larger trade finance operations in the DIFC. Generally, credit committees are tasked with considering TBML risks in parallel to credit risks; however, this does not necessarily mean that TBML risks are given specific focus and assessment.

Depending on the nature, scale and complexity of trade finance activities, we regard inter-department forums/committees beneficial for sharing and assessing relevant information for managing TBML risks.

2.2.4 THREE LINES OF DEFENCE

The first line of defence is described by the Basel Committee on Banking Supervision¹⁹ as the business line management and staff who are generally responsible for identifying and managing the risks inherent in the products, activities, processes and systems for which they are accountable.

The second line of defence is generally limited to independent challenge of the business function's inputs to, and outputs from, the risk and compliance management framework for identifying, managing, measuring and reporting risks.

Money laundering reporting officers' (MLROs') roles at the Firms are somewhat blurred between the first and second line of defence. We did not observe any MLROs and compliance staff being singularly dedicated to an independent second line of defence role, but rather having elements of both. This may be appropriate given the nature, scale and complexity of Firms' operations in the DIFC, as long as there is an internal awareness of who and what function has accountability for managing the risks. We found that Firms could not identify, in a consistent and clear manner, the existence of a function dedicated to tasks typical of a second line of defence function. Furthermore, understanding of the three line of defence terminology is different across Firms.

Almost all Firms cited an internal audit function as the responsible party for the third line of defence and some Firms' internal audit departments reviewed the trade finance related activities to a certain extent, usually as part of their overall credit processes. However, internal audit reviews that specifically test the effectiveness of internal controls for managing TBML risks are not typically carried out.

2.2.5 CULTURE

Overall, some improvement has been noted in the "tone from the top" in respect to TBML risks. However, this does not appear to be trickling down through Firms

¹⁹ Basel Committee on Banking Supervision, Principles for the sound management of operational risk, June 2011.

adequately. Our general observations include:

- TBML risks require greater emphasis and should be regarded with the same importance as credit risks;
- In some Firms, senior management demonstrates awareness of TBML risks; however, they have not followed through with defining their TBML risk appetites and policies. As such, relevant and required oversight is limited; and
- In cases where TBML risk appetite and risk owners are defined (e.g. the relationship managers), risk owners are not involved nor kept informed throughout the transaction cycle. This calls into question the extent of responsibility that may be exercised given that risk owners may have limited visibility upon transactions conducted by customers.

3 | SKILLS, KNOWLEDGE AND EXPERIENCE

3.1 INTRODUCTION

Training is an essential element of the systems and controls needed for effectively combating TBML risks. In addition, the complexity and myriad of ways in which trade finance may be used to aid and abet financial crime further confirms and supports having adequate staff²⁰ on the front lines. Those charged with performing key controls must have a certain minimum level of experience and knowledge²¹ in trade finance.

Relevant and regular training should be conducted to enable employees, including members of senior management, to recognise and deal with AML related issues²². Training should include the prevailing techniques, methods and trends in money laundering relevant to the business. It should also be appropriately tailored to activities, products, services, customers, distribution channels, business partners, and the level and complexity of its transactions. The different TBML risks and vulnerabilities associated with these matters should be clear to employees.

Firms should ensure that all employees are and continue to remain fit and proper, competent and capable of performing their functions. All employees should continue to maintain their competence by keeping abreast of market, product, technology, legislative and regulatory developments and ensuring that this knowledge is applied.

The Governing Body and senior management play an important role in ensuring strong systems and controls are in place for combatting TBML risks. Senior management competencies should include awareness of the Firm's TBML obligations and, at a minimum, knowledge and application of effective methods for exercising their duties, including management, monitoring and control. Senior management also have a part to play to ensure that the relevant training delivered to staff is effective.

“INCLUDING RED FLAGS, CASE STUDIES, AND SCENARIOS IN EMPLOYEE TRAINING HELPS EMPLOYEES UNDERSTAND AND APPLY A SENSE OF AWARENESS OF TBML RISKS”

3.2 FINDINGS

3.2.1 TRAINING AND AWARENESS PROGRAMMES

Almost all Firms conduct some form of generic AML / sanctions training for their staff, however it is of concern that Firms do not adequately address TBML risks in this training.

²⁰ As prescribed in GEN Rule 4.2.4 (Authorised Firm Principle 4)

²¹ As prescribed in GEN Rule 4.2.4 (Authorised Firm Principle 4) and GEN 5.3.19

²² As prescribed in AML Rule 12.1

Most Firms' training programmes and the associated training material do not cover any Red Flags, case studies, or scenarios which would help employees understand and apply a sense of awareness of TBML risks. The training programmes are not effective in explaining to staff detection techniques, internal procedures for identifying Red Flags and how to deal with Red Flags should they arise. This finding was consistent with outcomes of our interviews with key staff.

Training programmes specifically in relation to TBML risks tend to be driven by compliance and legal staff. In some Firms, it is evident that internal and/or external trade finance specialists are involved in contributing to the training programmes by sharing their insights, which we believe is an example of a better practice.

3.2.2 SKILLS, KNOWLEDGE AND EXPERIENCE OF STAFF

Due to the detailed and sometimes complex nature of trade finance business, adequate experience and training at the front line is an important factor in being able to undertake trade finance activities safely. This equally applies to being able to detect TBML. As such, Firms who demonstrated good systems and controls for managing TBML risks tend to employ staff with a significant level of experience. It is acknowledged that being able to recruit experienced staff is a challenge. As such, an effective training programme for junior staff with oversight from senior trade finance specialists is critical.

Many employees could identify basic TBML concerns. However, we were disappointed to note that some employees are of the view that being competent in assessing credit and operational risks generally means that one can identify TBML risks and therefore specific knowledge of TBML risks is not important. While this can be true for some TBML risks, it certainly is not the case for all. Credit and operational risk assessment cannot be a substitute for TBML risk management.

3.2.3 OTHER OBSERVATIONS

- **Recruitment** – branches of foreign banks should have appropriate authority and willingness to recruit from outside the Group to ensure that they

employ appropriately skilled and experienced staff.

- **Qualifications** – These tend to be focused on credit, operational risk and technical matters. Content of qualifications should also include managing TBML risks.

“FIRMS WHO DEMONSTRATE GOOD SYSTEMS AND CONTROLS FOR MANAGING TBML RISKS TEND TO EMPLOY STAFF WITH A SIGNIFICANT LEVEL OF EXPERIENCE IN TRADE FINANCE”

4 | RISK ASSESSMENT

4.1 INTRODUCTION

Firms should take appropriate steps to identify and assess money laundering risks to which its business is exposed, taking into consideration the nature, scale and complexity of its activities. By identifying the relevant TBML vulnerabilities, Firms will be better equipped in translating such risks into their policies, procedures, systems and controls and, as a result, preventing and potentially mitigating them to the extent possible.

The Governing Body and senior management play an important role in this area, especially with regard to communicating the Firm's risk appetite to staff to further ensure that it has been

²³ As described in The DFSA Rulebook, AML module, Chapter 5.

²⁴ As described in The DFSA Rulebook, AML module, Chapter 6.

translated into their systems, controls and relevant AML Business Risk Assessments²³ and Customer Risk Assessments.²⁴

The results of the AML Business Risk Assessments will feed into assessing the relevant risks posed to a Firm by their customers. Firms should undertake a risk-based assessment of every customer and assign a risk rating that is proportionate to the customer's money laundering risks.

Given the above, our Review focused on appropriate consideration of TBML risks in Firms':

- a) AML Business Risk Assessments; and
- b) Customer Risk Assessments, rating methodologies and relevant arrangements for on-going updates.

4.2 FINDINGS

4.2.1 REVIEW FOCUS AREA: AML BUSINESS RISK ASSESSMENT

Our review of most Firms highlighted a need for improvement in assessing relevant TBML risks in their AML Business Risk Assessment. Firms do not give appropriate consideration to risk factors including, but not limited to, their trade finance products, complexity of structures, volumes, customers, underlying goods, countries and any emerging risks. For a handful of Firms, their trade finance risk appetite was implicitly evidenced in their policies and procedures. However, we do note that this does not eliminate the requirement of identifying and adequately assessing the AML Business risks and the development of an explicit risk appetite to enable Firms to establish relevant controls around such risks.

Generally, some of the findings of this Review appear to be similar to the findings highlighted in the DFSA's Annual AML Report²⁵ published in April 2015, as well as the DFSA's letter to Senior Executive Officers (SEOs) published in March 2016. This raises concerns in relation to Firms not keeping up to date with on-going requirements and regulatory communications.

4.2.2 REVIEW FOCUS AREA: CUSTOMER RISK ASSESSMENT

Generally, all Firms have in place a documented Customer Risk Assessment methodology that takes into account the overall risk factors when calculating the relevant risk ratings. However, we note that most Firms' Customer Risk Assessment methodologies are not sensitive enough to TBML risks and are not kept up to date. Relevant methodologies also lack information in terms of certain trigger events for updating customer risk scores. This shortcoming is further reflected in their systems and controls as most Firm's customer files do not contain records showing customer risk scores being revisited and subsequently being updated where appropriate.

To perform an effective customer risk assessment and on-going monitoring of customer behaviour, Firms need to first establish a base-line understanding of individual customers' expected nature of transactions and behaviour. Procedures for establishing a base-line understanding varied across all Firms.

Themes we observed included:

- Some Firms do not have relevant procedures in place, which is a poor practice; and
- Other Firms receive a list of expected underlying goods and volumes from customers at the on-boarding stage. The information is inputted in an internal system and used for monitoring on an on-going basis.

There is a need to integrate available information from all departments to establish a base-line customer information set.

5 | CUSTOMER DUE DILIGENCE AND MONITORING

5.1 INTRODUCTION

There are many ways in which trade finance products may be used in TBML and financial crime. Firms'

²⁵ Annual Anti-Money Laundering Return: Analysis and guidance. DFSA, April 2015.

obligations are therefore becoming more complex. As such, the challenge for Firms is to achieve a balance between effectiveness (i.e. effectively identifying suspicious behaviour in trade finance related business) and commerciality (i.e. timely and viable processes that serve the needs of customers and the international trading community).

Generally, CDD²⁶ should be carried out on the customer who is the “instructing party” for the purpose of a particular trade finance transaction. The instructing party may already be an existing customer of the bank but, if not, due diligence must be carried out on the instructing party before proceeding with the transaction. Additional due diligence on other parties and beneficiaries of letters of credit (LCs), and possibly the transaction itself, may be undertaken depending on the underlying risks.

For export LCs, the instructing party for the advising/confirming bank is the issuing bank. Generally, the advising/confirming bank carries out appropriate due diligence on the issuing bank in line with generally accepted practices for correspondent banking which entails regular reviews of the correspondent banking relationship. Consequently, due diligence on the issuing bank need not be performed each time the advising/confirming bank receives an LC.

Against this backdrop, there is a body of knowledge that has already been built up both internationally²⁷ and within Firms identifying certain methods and indicators used by relevant parties to a trade finance transaction to advance TBML and financial crime. We refer to such information as “Red Flags”.

Given the TBML risks, at a minimum, we expect Firms to incorporate within their systems and controls such Red Flags using a risk-based approach that takes into account their particular role in trade finance. Record keeping should also be used to demonstrate that Firm’s on-boarding and on-going CDD is effective.

In light of the above, the Review focused on Firms’ systems and controls for undertaking on-boarding and on-going CDD and the nature of the CDD that is being carried out for trade finance related activities.

5.2 FINDINGS

5.2.1 USE OF THE RISK-BASED APPROACH

We observed that the risk ratings of customers (see Section 4 - Risk Assessment) are not used to determine the nature and extent of CDD conducted either initially or for on-going monitoring of transactions. Instead, Firms tend to apply Enhanced Customer Due Diligence (“EDD”)²⁸ right across their customer base with the belief that the approach dispenses with the need for allocating a low, medium or high risk rating to customers. The risk with employing this common approach includes:

- Firms may not appropriately assess the risks perceived by inherently high risk customers and as such not carry out the appropriate and required level of EDD; and
- It may encourage unnecessary amounts of CDD for customers that warrant a more simplified approach, thereby misdirecting resources away from identifying and monitoring the inherently high risk customers that require upmost due diligence.

5.2.2 POLICIES AND PROCEDURES

Policies and procedures generally demonstrated weaknesses in relation to CDD and on-going monitoring of TBML risks. Common weaknesses include:

- AML policies and procedures are not tailored to specific risks inherent in trade finance;
- Policies and procedures do not generally draw a distinction between CDD, Simplified Customer Due Diligence (“SCDD”) and EDD and the minimum initial and on-going checks required for each; and
- Firms’ processes, in practice, differ from the information contained in the policies and procedures. In these cases, Firms significantly rely on experienced staff to know what to do and be mindful of the Red Flags that could raise TBML suspicions.

²⁶ The DFSA requires all Firms to undertake both on-boarding and ongoing CDD. These requirements are contained in chapter 7 of the AML Module. Similarly, the DFSA requires Firms to maintain effective systems and controls around sanctions (chapter 10 of the AML module). In addition, the DFSA expects Firms to maintain records including all documentation and information obtained in undertaking initial and ongoing CDD (see section 14.4 of the AML Module).

²⁷ FATF and Wolfsberg, FCA, MAS, HKBA.

²⁸ AML Rule 7.4

5.2.3 INITIAL CDD AND ON-GOING CDD SYSTEMS AND CONTROLS: INCORPORATING RED FLAGS

Effective processes for combatting TBML risks will typically rely to some extent on employees' understanding and applying relevant Red Flag indicators that could alert them to high risk transactions or suspicious activity. As already discussed, there are many Red Flags that have been identified (for example by the FATF, Wolfsberg and other regulators) and are being expanded on as TBML and financial crime risks evolve. The challenge for Firms is to embed these Red Flags into their AML systems and controls effectively. Most Firms in our sample do not fully address this challenge and the divergence of practices is significant.

The following themes were identified:

- Some Firms do not incorporate any Red Flags in their systems and controls and rely entirely on staff experience. This includes Firms who do not produce any documentation on Red Flags for their staff to monitor against;
- Some documentation accompanying policies and procedures contain Red Flags; however Firms cannot demonstrate how these are incorporated within CDD and on-going CDD. In some instances, the list of Red Flags is also materially incomplete;
- Some Red Flags are incorporated, however they are credit risk driven; and
- Some Red Flags are incorporated in systems and controls, although in a haphazard manner and cannot be consistently demonstrated.

We advise Firms to keep records of all Red Flag alerts generated along with relevant rationale on the closure of such alerts. The absence of Red Flag alerts, or inadequate records on how alerts are closed, could therefore be an indication of ineffective systems and controls surrounding Firms' on-boarding and on-going CDD in respect to TBML risks and potentially leading to less internal and external SARs being raised. Some Firms are not keeping adequate records of Red Flag alerts and this exacerbated the poor findings in relation to Red Flag systems and controls.

5.2.4 ON-GOING CDD AND TRANSACTION MONITORING CONDUCTED BY OTHERS

A significant portion of trade finance business originates from other banks. In particular, instructing parties are often other banks²⁹ or a member of the same Group. In both cases, the DFSA recognises that various CDD and transaction monitoring will already be performed by these instructing parties, at various levels of rigor, according to their own policies and procedures. This does not mean that Firms may unconditionally rely entirely on CDD undertaken by these respective counterparties.

Reliance on other banks may only be appropriate in situations where Firms have established on-going relationships with instructing banks (as detailed below), and that these banks have established a good track record with the Firm in question³⁰ to warrant such reliance, subject to their conduct and results of on-going monitoring.

Firms generally do not perform on-going due diligence on their instructing banks' AML systems and controls, or have a robust risk-based methodology to demonstrate appropriate reliance on instructing banks. Elements of appropriate processes may consist of, but are not limited to:

- Discussions with the bank's senior management and compliance staff;
- Review of the bank's policies and procedures for combatting financial crime risks;
- Review of compliance frameworks surrounding AML, which may include visiting the bank and utilising questionnaires;
- Consideration of the bank's country of origin and the AML-related regulatory actions taken by the competent authorities in that country;
- Utilising a risk-based approach to conduct on-going sampling of LC documentation to test whether the CDD or EDD performed by the instructing bank on importers/exporters conforms to the DIFC Firms' own standards and to the DFSA's expectations; and
- If the Firm's Group is undertaking the assessments listed above on the Firm's behalf, the Firm will assess

²⁹ Examples of instructions from other banks include LC advising, document collections and buyer credit.

³⁰ In order to establish such a track record, Firms need to have arrangements in place which are consistent with the DFSA's expectations set out in AML 8.1

these measures and assure themselves that they are effectively implemented.

Generally, an adverse result from any one of the above measures will lead to greater scrutiny of trades or ceasing the relationship.

We also noted that several Firms' CDD conducted on other banks is mainly focused on credit risks and the regulatory status of that party. This approach is not in line with the DFSA's expectations on how Firms should adequately control TBML risks.

Some Firms place unquestioning reliance on their Group without checking, on a periodic basis, whether the standards that would otherwise be applied in the DIFC are also met by Group entities operating in other jurisdictions. Evidence of good practice in this situation includes documented responsibilities between the two respective parties supported by appropriate oversight, gap analysis, and on-going sample testing.

5.2.5 INTER-DEPARTMENTAL PROCESSING OF TRADE FINANCE TRANSACTIONS

Some Firms have several departments, such as the back office and operations departments, which might be located outside of the DIFC. These departments are responsible for monitoring transactions once the DIFC entity has performed the on-boarding CDD in the first instance. We identified some general themes in relation to such arrangements:

- Caution needs to be exercised when implementing too many automated procedures and data entry to ensure that this does not eliminate human judgement. The challenge for Firms utilising such arrangements is to achieve the right balance between automation and human judgement.
- Customer facing staff, e.g. relationship managers and marketing staff tend to possess a deep knowledge of their customers that is sometimes untapped unless an alert is triggered.
- The lack of customer facing staff involvement and the tendency for employees to single-mindedly focus upon their own function means that the process becomes fragmented, with no

one person or group of people having an end to end knowledge of the processes involved and indeed the customer relationship.

Some Firms have recognised these challenges and therefore established interdepartmental forums and committees in order to bridge knowledge across the process chain with the aim of catching risks or issues that could fall between the points where departments intersect. It is advisable that the person who generally interacts with the customer most frequently is aware of all customer transactions.

5.2.6 SANCTIONS: SYSTEMS AND CONTROLS

Generally, better results were found within Firms in relation to their sanctions screening processes, with the exception of dual use goods³¹. This is consistent with the findings of other regulators which suggest that Firms place a greater emphasis on sanctions compared to financial crime. Nevertheless, important improvements are required in this area including:

- Adequately documenting the sanctions screening processes;
- Inconsistencies of which parties were screened against sanctions lists; and
- The manner in which alerts were closed and justification for such closure.

We also noted some good practices including:

- Parties to a transaction being screened initially and just prior to execution of the transaction; and
- Screening ships, agents and all associated parties contained within the information at hand.

5.2.7 TRADE BASED MONEY LAUNDERING AND COUNTER TERRORIST INDICATORS

Our Review of on-boarding and on-going CDD systems and controls assessed a number of Red Flags. In respect to under/over invoicing and dual use goods, we found overwhelmingly that Firms are doing more on under/over invoicing risks than dual use goods. Many Firms lack appropriate controls to alert them on dual use goods.

³¹ Dual-use goods include software, technology, diagrams and other goods that can be used for civilian and military purposes.

a) Under or over invoicing

We expect Firms to apply a risk-based approach when checking prices and to be aware of some of the inherent factors which may raise the risk of under/over invoicing³² such as related or connected parties.

Overall, we found that Firms have challenges in this area, particularly due to the nature of the underlying products being financed and the availability and accuracy of third party data sources. For example, the prices of diamonds differ substantially depending on whether they were cut or rough, as well as the specifications. Staff need to know the most appropriate sources to review in order to ensure that their checks are effective. Some additional issues we noted include:

- No pricing being checked or reliance on a “reasonableness test”;
- Prices being checked, however a lack of documentation evidencing this;
- Policies and procedures not updated to provide guidance to staff on suitable sources to use or the appropriate thresholds where differences between prices were deemed satisfactory. Where the differences exceeded the stated threshold, there is also a lack of guidance on the appropriate follow-up steps and documentation requirements that staff needed to perform; and
- On-going CDD that involved the checking of prices is potentially being done elsewhere in the Group. In these instances there was no evidence of Firms checking on an on-going basis that this was being done.

b) Dual use goods

Overall, most Firms need improvement in this area (including policies, procedures, systems and controls) in order to identify high risk goods. This is a challenging area, particularly within the technical knowledge that may be required to identify such goods. However, staff rarely received training in this area, nor did Firms construct guidance material that would aid their employees. Some Firms do, however, maintain and check against a list of prohibited goods.

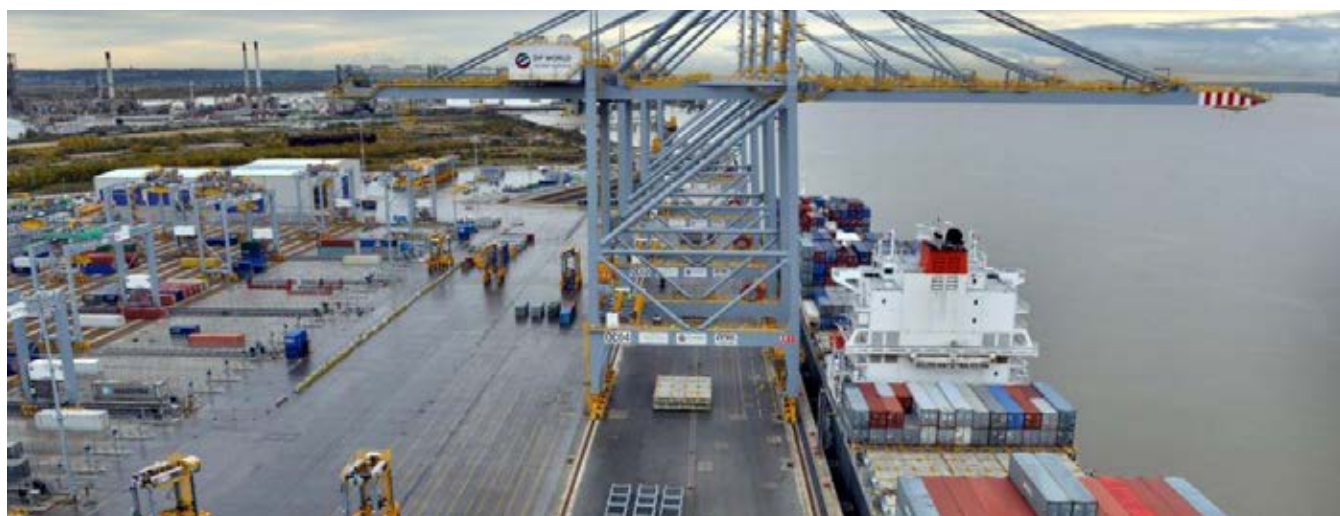
c) Other indicators

Our review of on-boarding and on-going CDD included discussions with Firms around methods used to identify high risk transactions. Some of these included, but were not limited to, unusual / suspicious: customer behaviour, deal structures, shipments, goods, countries, payment instructions and discrepancies in documents.

Overall, the results are not consistent between Firms. We do note, however, that Red Flags associated with sanctions risks are given a higher emphasis by Firms, such as checking ships, ports of loading and ports of call. Appendix B includes the outcome of these discussions.

5.2.8 RECORD KEEPING

Generally, most Firms have documentation to support on-boarding CDD; however this is not always the case for on-going CDD. For on-going CDD processes, there is a lack of documentation in place to demonstrate the process for identifying unusual or high risk transactions.



³² Trade Finance can be used to disguise the illegal movement of funds or value that typically involves falsifying the price, quality or quantity of goods. The outright faking of the existence of goods is also a method. Such activity is usually dependent on some form of collusion between the importer and exporter.

APPENDIX A – BETTER PRACTICES

1. BUSINESS MODEL AND GOVERNANCE

- Strong awareness, among all levels of staff, that whilst some aspects of TBML are covered in a credit risk assessment, that this is not a substitute for TBML risk assessment and monitoring.
- Clear division of roles, responsibilities and ownership of risks relating to critical functions and controls.
- All customers are on-boarded and TBML risks are assessed, including those customers to whom Arranging and Advising services are being provided, as required by the DFSA Rules.
- Where reliance is placed on Group functions, a gap analysis of policies and procedures has been carried out against DIFC requirements and sample testing carried out to ensure implementation.
- Management information includes TBML risks with the objective of providing a beneficial view of how TBML risks are evolving in its trade finance business.
- Share relevant information for managing TBML risks by establishing inter-department forum/committees.
- TBML risks are considered in the Firm's enterprise-wide risk management framework.
- Internal audit performed against DFSA and international regulatory expectations for TBML risks. The internal audit covers trade finance process end-to-end.
- Pricing of trade finance products are linked to risk.
- The strength, weakness, opportunity and threat (SWOT) analysis for trade finance business is updated on an on-going basis and incorporated into the AML Business Risk Assessment process.
- Independent senior management oversight of TBML controls.

2. SKILLS, KNOWLEDGE AND EXPERIENCE

- Emphasis placed on hiring experienced staff and encouraging employees to possess formal qualifications specific to trade finance and AML. Where relevant experience is not identified within the Group the Firm considers recruiting from outside the Group. Local operations have significant involvement in the recruitment process.
- Training tailored to specific trade finance products and the AML / sanctions risk in those products. Training is supported by appropriate and easily accessible guidance documents and case studies.
- Training covers detail about the systems and controls in place to control TBML risks.
- Training is regularly updated to incorporate new developments, Red Flags, internal experience and regulatory guidance.
- Trade finance and financial crime specialists play a significant role in the design and delivery of training.
- A competency programme is established, according to role and level of involvement in trade finance activities at the Firm. It is formalised, tracked and linked to performance assessment and key performance indicators (KPIs).

3. RISK ASSESSMENT

- Detailed AML Business Risk Assessment that considers the inherent risks in relation to each of the Firm's trade finance products (including any emerging risks) and the control framework including: management information, training, policies and procedures, oversight, as well as the transaction control framework. A risk appetite is explicitly documented.
- AML Business Risk Assessments obtains appropriate input from all areas of the Firm, including relevant business lines.
- The risk scoring methodology and tool is sensitive to different trade finance products which generally pose higher AML risks. Jurisdiction risk is important, however, it is not the dominant factor when determining the total customer risk score. Not all individuals from the same country present the same overall AML risk profile.
- Procedures are established for capturing and accessing a customer's usual and expected nature of transactions, together with effective methods that harness the information for the purpose of performing on-going CDD.
- Customer files contain rationale justifying changes in customer risk scores.
- Customer risk ratings/scores are refreshed and documented on an on-going basis based on risk rating and significant events.
- A wide range of trigger events for updating customer risk scores spanning sanctions, the issuance of new regulatory guidance, and offering of new products.
- On-going oversight of the effectiveness of the scoring tool and accuracy of information inputted into the scoring tool is checked regularly. As part of the on-going oversight, the Firm ensures that the scoring tools are not being misused by staff.
- In circumstances when the operations department is responsible for identifying anomalies in customer behaviour, there are effective lines of communication between the operations department and the front office staff (where knowledge about the customer commonly resides).
- Arrangements in place for periodically updating the customer risk assessment methodology.

4. CUSTOMER DUE DILIGENCE AND MONITORING

CULTURE

- Compliant behaviour and appropriate culture is linked to staff performance outcomes.
- "Tone from the top" considers TBML as important as credit risk.
- Staff on the front lines own and are accountable for TBML risks.

POLICIES AND PROCEDURES

- Documented procedures address what due diligence must be carried out on the instructing parties depending on the Firm's role in the transaction. It identifies the checks necessary and the circumstances in which checks are performed for non-customer beneficiaries, or recipients, of an LC or bills collection.
- Policies and procedures include the type of information to be obtained as part of the Firm's due diligence measures on instructing parties who are banks.
- A comprehensive Red Flags list organised according to various trade finance product/transaction types and describes how monitoring is undertaken for each.

- Policies and procedures are frequently updated for TBML risks.
- Policies and procedures distinguish between CDD, SCDD and EDD.

INSTRUCTING PARTIES WHO ARE OTHER BANKS

- Due diligence upon instructing parties who are banks includes discussions (and interviews) with the bank's senior management and compliance, review of policies and procedures to combat financial crime risks, as well as performing visits. The assessment includes review of compliance frameworks surrounding AML and sample testing of transactions on an on-going basis utilising a risk-based approach. If the Firm's Group is undertaking this assessment on the Firm's behalf, the Firm will test these measures.

ON-GOING CDD AND TRANSACTION MONITORING

- Clear guidance established for staff to identify who should be regarded as a customer and instructing party.
- Risk ratings determine the nature and extent of CDD conducted on customers both initially and for on-going monitoring of transactions.
- Higher risk transactions are automatically detected by the system and the customer facing staff (relationship manager) is notified for review.
- Centralised record of all alerts which are case managed in an efficient and effective manner. Records and rationale are kept describing the action taken on each alert. Such a system will assist in generating management information and improving the auditability of the alert systems.
- List of prohibited types of customers and goods.
- Vessel checking is done through multiple sources. If ports of loading and discharge are stated in general terms then the transaction is automatically rejected.
- Monitoring of transactions throughout the trade cycle.
- Monitoring performed over the effectiveness of automated systems.
- Third party advisors confirm if goods have been screened, valued, and sent, with all associated trade based documents. This is to check that the goods have been shipped through proper means. Oversight and on-going due diligence of such third parties is carried out.
- Sanctions lists are complete and refreshed frequently, including review of local news sources for government pronouncements that may not be formally published.
- Screening is performed on all relevant parties to a transaction.
- Standard wording has been provided to relationship managers to use when declining transactions on sanction issues.

APPENDIX B - RED FLAG INDICATORS

INDICATORS FOR HIGHER RISK TRANSACTIONS (NOT EXHAUSTIVE)

FINDINGS

CUSTOMER'S BEHAVIOUR

Examples include customer engaging in transactions that lack a business sense and are inconsistent with their stated business strategy; deviation from historical pattern of trade activity; reluctance to provide clear answers to routine questions.

Most Firms tend to undertake such monitoring to some extent with varying levels of effectiveness. The range of monitoring practices include:

- Some Firms use internal systems to capture past and usual behaviour and therefore be alerted to unusual customer behaviour.
- At other Firms, those tasked with monitoring transactions do not have requisite knowledge of the customer in order to undertake monitoring effectively. For example: lack of communication between operations and front office, or those in the Firm who have the most complete understanding of the customer's expected behaviour.
- On the other end of the scale, some Firms do not have any procedures in place with regards to monitoring. This includes not collecting adequate information on past customer behaviours.

DEAL STRUCTURES

Examples include deal structures beyond the customer's capacity or expertise; improbable goods or quantities; unusual country of origin or destination; exceptional complexity or unconventional use of financial instruments, LC counterparties connected to the applicant or beneficiaries.

- There is generic guidance in policies and procedures such as not dealing with shell banks, but they are not comprehensive enough.
- There is a general over reliance on employee experience.
- There is a lack of supporting tools, guidance and training.

SHIPMENTS

Examples include the shipment does not make economic sense such as a large container being used for a small amount of low-value goods; quantity of goods exceeds the known capacity of shipping container or tanker capacity; abnormal weights for goods; use of inappropriate shipment means (e.g. frozen goods being shipped in a vessel unequipped with refrigeration); unusual shipping routes or transshipment points.

- Given the importance Firms place on sanctions screening, Firms tend to perform some checks in this area. However, not all applicable aspects are considered.
- One Firm carried out checks on a historic basis rather than throughout the trade cycle. This approach has its risks and may not be effective as using real time checking using a risk-based approach.
- There is use of third party data sources (some of which are free).
- Checking varied depending on the extent of information available. Some Firms are content with not being provided shipping details without first assessing whether this is appropriate given their understanding of the issuing bank's systems and controls.

INDICATORS FOR HIGHER RISK TRANSACTIONS (NOT EXHAUSTIVE)

FINDINGS

DISCREPANCIES IN DOCUMENTS

Examples include descriptions of the goods differing significantly, or shipment location, and/or shipping terms are inconsistent with the LC, changes in the quality of goods shipped or shipment locations, unauthorised alterations or modifications to documents, LC contains non-standard clauses or phrases, and bill of lading not consigned to a named party.

- Most Firms carried this out to some extent due to their role in the trade cycle.
- Financial crime triggers in this area are not comprehensive enough.

USE OF INSPECTIONS

Examples include use of external experts, visiting warehouses where goods are stored to determine existence, physical verification of goods shipped or present on the wharf.

- Most Firms undertake some verification procedures through off-site visits as part of usual credit assessment procedures.
- One Firm uses an agent to verify physical shipping of goods using a risk-based approach.

GOODS

Examples include compliance with import or export control regulations, goods are out of line with customer's business; shipment is of a shipment size which appears inconsistent with the scale of regular business (of importer or exporter); unusual ports of origin for commodities; packaging inconsistent with commodity or shipping method.

- Generally there is over-reliance on employee experience with a lack of formal guidance and controls to ensure that higher risks in this area are identified.
- However some Firms do highlight that appropriate and relevantly experienced personnel are not always available.

COUNTRIES

An example includes attempts to circumvent or disguise the country of origin.

- Generally Firms tend to undertake such checks adequately.
- A few Firms do not have internal country lists based on their own internal risk appetite.
- One Firm obtains country of origin certificates to determine the origin of goods (e.g. crude oil).

PAYMENT INSTRUCTIONS

Examples include unexplained illogical or last minute changes to payment instructions; payment to be made to beneficiary's account held in a country other than stated location; unusually favourable payments terms; unusual trigger point for the payment; a third party funds the LC value fully or partially with no apparent link to the transaction; request to pay a third party.

- Some Firms have stipulated procedures in place to avoid specific scenarios.
- Aside from identifying unacceptable payment scenarios, most Firms do not implement arrangements in order to assess and challenge more qualitative considerations such as unusually favourable payments terms.
- Transactions between related parties are considered to some extent.



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