

WHAT DOES THE RISK OF SANCTION CIRCUMVENTION MEAN FOR BELGIAN BANKS?

The National Bank of Belgium (NBB) expects all financial institutions (FIs) with a presence in Belgium to follow the directives set out by the European Union (EU) in regard to the latest sanctions packages. In short, Belgian FIs must ensure that they are not facilitating the movement of funds to or from sanctioned individuals or entities. In this article, we will argue that robust AML and transaction monitoring systems are key to avoiding non-compliance and the consequences of enabling sanctions circumvention.

OVERVIEW OF RECENT SANCTIONS

In response to Russia's incursion in Ukraine, the EU imposed a series of comprehensive and robust packages of sanctions designed to restrict the Kremlin's ability to finance the war. These actions have made Russia the most sanctioned country in the world. To intensify pressure on Russia and its close strategic ally Belarus, the EU imposed seven packages of sanctions spanning individuals and state entities. An almost complete embargo on Russian oil was introduced, and Russia's

largest banks are excluded from the SWIFT system. At this stage, the measures adopted by the EU affect over 108 entities as well as 1,212 individuals¹.

Alongside the EU, the United Nations (UN), the US Office for Foreign Assets Control (OFAC), and the Office of Financial Sanctions Implementation (OFSI) in the United Kingdom have also imposed sanctions on Russia.

DIRECT RISK OF SANCTION CIRCUMVENTION

Organizations have been forced to consider how they can best reconcile the different sanction regimes while limiting the impact on their day-to-day operations. In particular, maintaining robust transaction screening as well as transaction monitoring controls has become even more important in recent months for Belgian financial institutions that either know or suspect they might have exposure to sanctioned entities.

The risk of sanctions circumvention is a real concern. Historically, there have been three main ways that sanctions are circumvented: the use of shell companies, via trade finance, and by leveraging correspondent banking relationships.

Sanctioned entities or individuals often use a network of shell companies located in countries bordering sanctioned, or tax

1. https://ec.europa.eu/info/strategy/priorities-2019-2024/stronger-europe-world/eu-solidarity-ukraine/eu-sanctions-against-russia-following-invasion-ukraine_en

havens, countries. Unscrupulous individuals and entities may thus use shell companies to funnel money into sanctioned entities, sanctioned jurisdictions, and/or for the purchase of sanctioned goods. Shell companies allow - along with providing a level of anonymity - to move money in a short burst of activity that makes it tougher for financial institutions to detect. The risk for financial institutions is related to the complexity of identifying the ultimate beneficial owners hidden behind shell companies, making it therefore harder to spot the involvement of sanctioned jurisdictions, goods, entities, or individuals in the related transactions.

Trade finance schemes are also a common option to evade sanctions. They lead to the provision of no, or conflicting, documentation to support the transaction, as their main purpose is moving money undetectably. Sanctions circumventers may also alter legitimate trade finance, or make several amendments to trade finance documents, to obfuscate the goods, entities or jurisdictions involved. This scheme is particularly challenging to detect, as faulty paper trails make it tough for financial institutions to prevent and detect trade finance schemes, and monitoring is only as good as the documentation the financial institution obtains for each transaction.

RISK THROUGH CORRESPONDING BANKING SERVICES

It is important to emphasize that financial institutions with no direct exposure to sanctioned individuals, or to sanctioned companies, still face significant indirect sanctions risks through correspondent banking services they provide to other banks.

Correspondent banking acts as a go-between cross-border transaction between banks that lack formal ties. This forces financial institutions to rely on so-called “respondent” banks to conduct adequate due diligence on their customers. Correspondent banks typically have no direct relationships with either of the underlying parties in a transaction. Their clients, the respondent banks, carry out customer checks, including identifying beneficial owners and sources of funds.²

There is a possibility that the correspondent banks’ AML systems will not detect the risk due to these third parties not having sufficient AML/KYC programs in place. Ultimately, this can lead banks with no direct exposure to sanctioned individuals or entities, to unwittingly facilitating the money transfer for the benefit of sanctioned entities, through nesting³ or due to the lack of clarity of the ultimate beneficial owner’s identity.

An indirect exposure to Russian sanctioned entities or individuals can serve as an example to the above point: banks will be especially exposed to indirect sanctions risks through their correspondent ties to financial institutions in countries that have strong links to Russia, or little/no sanctions program in place, such as China or India.

STRONG DUE DILIGENCE PROCESSES CAN HELP BELGIAN BANKS AVOID THE RISK OF SANCTIONS CIRCUMVENTION

To prevent the risk of sanctions circumvention, and avoid reputational and financial damage, financial institutions need to strengthen their processes, procedures, and policies for transaction screening (which involves verifying customer identities and an ongoing screening of their transactions) and transaction monitoring (observing customer transactions in

real-time, or retroactively to spot trends and red flags).

It may be tricky to identify ultimate beneficial owners (UBOs) of companies to check whether any of them are sanctioned, as ownership is often hidden in holding companies with opaque ownership structures. The European Commission does not

2. <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/banks-face-hidden-sanctions-risk-amid-complex-correspondent-banking-system-69743257>

3. Nested, or downstream, correspondent banking refers to the use of a bank’s correspondent relationship by a number of respondent banks through their relationships with the bank’s direct respondent bank to conduct transactions and obtain access to other financial services. Nesting may be a way for regional banks to help small local banks within the respondent’s region obtain access to the international financial system, or to facilitate transactions where no direct relationship exists between banks. (<https://www.bis.org/bcbs/publ/d405.pdf>)

provide a universal guidance with respect to what constitutes reasonable efforts to identify sanctioned parties in a company structure. There is no one-size-fits-all model for due diligence - it may depend (and be recalibrated accordingly) - on the business specificities and the related risk exposure.

Each financial institution should develop, implement, and regularly update a sanctions compliance program that reflects their business models, geographic and sectoral areas of operations, and aligns with the related risk assessment. Such sanctions compliance programs can assist in detecting red flag transactions that can be indicative of a circumvention pattern.

RISK-BASED APPROACH DUE DILLIGENCE

A risk-based approach due diligence is the most recommended course of action to adopt. This usually consists of a risk assessment, multi-level due diligence, and ongoing monitoring. It includes periodic reviews of the customer due diligence information. Due diligence may translate into the screening of beneficiaries of funds or economic resources against sanctions lists and further investigations due to adverse media.

For correspondent banking, for example – in line with the Financial Action Task Force (FATF) recommendations – correspondent institutions should also detect any changes in the respondent institution's transaction pattern or activity that may indicate unusual activity or any potential deviations from the correspondent relationship.⁴

When it comes to the detection of sanctions circumvention, financial institutions can, and should, utilize their transaction monitoring systems to have a clear grasp of what is happening around their clients' activity. An effective approach built around

existing transactions might include elements such as clear KYC red flags or having a clear understanding of what information is necessary for clients to make use of their services (i.e., if a service requires less information during the onboarding process than others, then there may be a potential gap that can be exploited).

In either of those two cases, having the right quality of information is key. Not only will this help organizations build better intelligence, but it will also allow them to implement controls that consider classic sanctions avoidance schemes, such as increases in transactions that are below a certain threshold to trigger investigations, the presence of counterparties in high-risk countries, and/or the use of forged shipping instructions or invoices. Another positive effect of having good quality data is that it allows a better pattern detection across entities when it comes to registered addresses, transaction activity or beneficial owners.

ALTERNATIVE INVESTMENTS AS MEANS TO LAUNDER MONEY AND BYPASS SANCTIONS

The Organized Crime and Corruption Reporting Project (OCCRP) published an article on May 3, 2022, based on the investigation of Dubai's real estate data, owned by foreign investors. The OCCRP shows that the city's lax financial regulations have been exploited by both criminals and sanctioned individuals as a funnel

to invest their illicit proceeds into the legal real estate market.

Cross-border ownership of real estate remains a blind spot for the current statistics on international investments. While progress has been made in the assessment and analysis of offshore financial wealth, little is known about offshore real

4. <https://www.fatf-gafi.org/media/fatf/documents/reports/Guidance-Correspondent-Banking-Services.pdf>

assets, as they are not covered by the multilateral automatic exchange of information between tax authorities that entered into force in 2017⁵. Furthermore, there are also long-standing concerns that offshore real estate may sometimes be used to launder money and to evade international sanctions⁶.

Some of the owners listed in the 2020 data obtained by the Center for Advanced Defense Studies (C4ADS)⁷, include over 100 members of Russia's political elite, public officials,

and businesspeople close to the Kremlin as well as dozens of Europeans allegedly involved in money laundering and corruption schemes (some of them being sanctioned individuals).⁸

For European banks, the risk of sanctions circumvention like the Dubai case may arise through their correspondent ties with Emirati banks.

BELGIUM: THE NBB SANCTIONS MONITORING

The National Bank of Belgium (NBB), as a supervisory authority for the financial sector, must check whether financial institutions falling under its jurisdiction are respecting their legal obligations. The NBB follows the provisions compiled in the sanctions lists published by the EU and the United Nations. At the national level, the Ministry of Finance and the National Security Council have the power to impose sanctions, which are usually in line with those of the EU and the UN. These legal powers are usually used to add physical persons or legal entities to what is informally known as the "national terrorist list"⁹.

In addition, if a given financial institution has business activities expanding into countries other than the European Union, it will have to abide by the lists published by other agencies such as the OFAC, or OFSI. The OFAC list affects all economic activity that involves, in any shape or form, a US-involved party (i.e., US-nexus). In some cases, the implication of these parties might be explicit, that is, when certain transactions include US citizens or US companies. However, and especially in the event of clearance activities, this involvement may not always be straightforward. Namely, the exposure to OFAC sanctions for Belgian entities might come in the form of intermediary banks

responsible for settlement activity relating to securities or by means of using third-party providers that are incorporated in the United States.

The uniqueness of the sanction regimes we are currently seeing extends itself to the disparity in sanctions emitted by the EU and those of the OFSI. Before Brexit, these lists were in most cases virtually the same. However, since the UK left the Union, these lists have become increasingly dissimilar, forcing Belgian financial institutions to increase their sanctions compliance programs by checking the OFSI sanction listings.

This concoction of sanctions with which Belgian institutions are expected to comply has forced the financial sector players to adjust to a new way of making business. After the Russian invasion, the NBB informed all financial institutions with a presence in Belgium, that it was going to follow the directives set out by the European Commission and that it expects all EU member states to adhere to the sanctions regime.

Those entities that willingly or unwillingly do not comply with the directives imposed by the Belgian regulator may be liable for criminal prosecution. Hence, sanctions circumvention is such a sensitive topic for financial institutions.

5. <https://www.oecd.org/tax/exchange-of-tax-information/implementation-handbook-standard-for-automatic-exchange-of-financial-information-in-tax-matters.pdf>

6. <https://www.taxobservatory.eu/wp-content/uploads/2022/05/APZ02022-2.pdf>

7. <https://www.c4reports.org/sandcastles>

8. <https://www.occrp.org/en/investigations/dubai-uncovered-data-leak-exposes-how-criminals-officials-and-sanctioned-politicians-poured-money-into-dubai-real-estate>

9. <https://finance.belgium.be/en/treasury/financial-sanction>

LESSONS LEARNED SO FAR

At Capco, we have been advising our clients on how to deal with this evolving situation since the beginning of the Russian invasion of Ukraine. From this experience we have learned the following lessons:

- It is critical for FIs to ensure that they are filtering their transactions adequately. This does not only entail screening transactions against sanctions lists, but also includes making sure that the different types of transactions have the relevant instruction fields checked. These fields may include addresses, bank details or free text. In other words, it is not sufficient to just screen the names of individuals/organizations involved in a transaction, FIs must investigate elements such as SWIFT messages to see what is being mentioned.
- Additionally, it is not enough to have several transaction monitoring scenarios in place. These need to be supplemented by safety-net scenarios to ensure that an alert is generated if the filtering checks miss out problematic transactions. Furthermore, it will be valuable to dedicate time and effort into developing new scenarios to be implemented in the system that respond to how individuals/institutions can use a particular FI to bypass the different sanctions regimes.
- Institutions should also consider re-certifying some of their clients. This would allow financial firms to reassess their risk exposure and discover new entities linked to sanctioned individuals as well as understanding how they can better protect themselves against sanctions circumvention.

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<https://www.statista.com/chart/27015/number-of-currently-active-sanctions-by-target-country/>



Has your financial institution been contacted by the NBB to review policies and identify gaps in your AML/transaction monitoring system? Do you have stringent measures in place to avoid the indirect sanctions risk stemming from correspondent accounts?

At Capco, we leverage our expertise in regulatory compliance and process efficiency to offer cost-effective solutions to help our clients identify gaps and provide a plan of action to safeguard their regulatory processes and procedures. For further information and to discuss how our team can assist you in your regulatory and compliance endeavours, do not hesitate to contact us.

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