

Shadowing trade

Compliance is everywhere. C-level executives to front-line employees and back-office operations staff are all impacted and engaged in a reality that can see a 'minor' error in judgment quickly escalate to become a major breach of compliance requirements. Alexander R. Malaket explores some of the key points of impact in trade services, and considers what steps might be taken to ensure adequate compliance without overburdening the business.*

Compliance: a global imperative

Compliance requirements are increasing, evolving and becoming more complex at all levels of the global economy, across all types of organizations and irrespective of national borders or even 'virtual' borders in cyberspace.

Compliance has shifted from a reactive task, somewhere in the background of business and trade, to a resource-intensive, expensive and top-of-mind activity that can influence business and strategic decisions in a very direct and overt manner, for all types and sizes of organizations.

The requirements around compliance, imposed from various jurisdictions, quite frequently on an extra-territorial basis, are such that expert resources to help define and validate or enforce these requirements are in very short supply, and the likelihood of matching compliance expertise with domain knowledge – especially in a business such as trade services – is slim indeed.

Compliance is here to stay, and will be at centre stage for some years to come. How can we manage the business/compliance dynamic to ensure that the legitimate compliance objectives are understood and well met, without paralyzing the business of trade finance and trade services?

Compliance: another flavour to a familiar challenge

Trade finance, including trade services, has a recurring challenge in most parts of the world, perhaps throughout the globe. That challenge is to be adequately understood by key stakeholders and business partners, so that its interactions remain effective and so that ill-informed perceptions about the business of trade are not the basis for critical decisions.

While many core business activities (in banking and

elsewhere) are reasonably well understood, and must cope primarily with acquiring an understanding of evolving compliance and regulatory requirements, trade finance and trade services managers have the added challenge of working to communicate the characteristics of their business, to stakeholders who have little understanding of, or interest in, trade finance.

Much in the way that even seasoned risk management executives can present serious impediments to the development of trade business when they make credit decisions based on inaccurate perceptions, compliance specialists who remain too far removed from trade finance and trade services will add a layer of complexity to the business. Poorly informed compliance officers will (as they have already in some instances) become an obstacle to the conduct of legitimate business.

This general challenge of trade banking, in making itself understood both internally and with external parties, is the result of several factors, including the esoteric nature of the business. However, it is also frequently the result of a passive and reactive approach by many trade bankers in managing stakeholder relationships and perceptions about trade finance. This has long been true between trade bankers and their commercial or corporate banking colleagues, as well as between trade and risk management. Even specialists in closely linked areas such as foreign exchange are often poorly informed about trade finance, with the result that many banks' cross-sell efforts related to trade finance are recognized as being only somewhat successful.

Compliance can very easily become a further example of this unfortunate reality, with the difference being that compliance can, and will, seriously affect the day-to-day conduct of trade banking – sometimes

to the point of operational paralysis – if the same approach is adopted.

Compliance is such a fundamental and pervasive aspect of business today, that if trade executives do not take a proactive, systematic and purposeful approach to managing their relationships with compliance specialists – specifically to ensure that trade finance is adequately and fairly understood – compliance frameworks will be imposed upon trade finance, and there will be no option at that time other than to react to misguided, unnecessary and disabling requirements.

A few characteristics and trends of note

Trade finance involves business across borders, often in emerging or higher-risk markets. It can involve significant sums per transaction, and is classified by authorities as a high-risk line of business in terms of money laundering and all the related dangerous and illicit activity. Trade services typically involve significant information technology, and the business as a whole is moving inexorably – if slowly – to web-enabled transaction processing and a web-based delivery model. The IT-related compliance requirements will only increase over time, as more of the business of trade finance is conducted through technology, and as more of the related communication and financial transactions are facilitated through IT solutions.

Trade banking is also affected, from a compliance perspective, by regulatory requirements in related lines of business. In Europe, the advent of the Single European Payment Area, or SEPA, is already shaping strategy and defining compliance and regulatory concerns for trade finance and trade services.

Finally, trade services are increasingly a viable candidate for outsourcing and offshoring, due to the cost drivers, and the availability of enabling technologies and processes. This trend is further supported by increasing acceptance (resignation?) among trade clients relative to the imperatives for banks to outsource and/or offshore certain types of processes.

Each of the above trends and characteristics carry significant implications, and make trade finance and trade services an almost irresistible target for restrictive and conservative compliance measures and requirements. Below we consider a few options for facilitating a constructive dynamic between trade finance/trade services and compliance.

This is a partnership, not a dictatorship

An effective compliance model is absolutely necessary

and legitimate in today's business and trade environment. Compliance is not a necessary evil, but a valuable element of corporate stewardship which will help shape sound business practices as well as constructive perceptions about those sound practices in the market. Business specialists, including trade services operations groups, must appreciate the commercial value of effective compliance programs, and must be encouraged and empowered to contribute positively to the development of such models and frameworks.

Similarly, compliance specialists must recognize that their role includes enabling the pursuit of legitimate business, and is not merely about prohibitions and limitations. Compliance needs to be an effective business partner, even in its oversight capacity and with appropriate 'arms length' interactions. The objective of compliance specialists is not to blindly apply the strictest compliance standards, behaving as taskmasters leveraging political pressure backed by sweeping regulatory requirements which are still in their infancy.

Trade executives ought to encourage and facilitate the development of domain-competent compliance specialists. While the 'naive view' can sometimes be helpful in consulting and audit roles, it should be complemented, in this discipline, with compliance expertise that can understand trade sufficiently to interpret regulatory and compliance requirements against practical transactions and business practices.

Given that compliance specialists are working in a nascent area where the rules are extensive and often unclear pending some type of legal decision or the setting of a precedent, trade executives will be well-served in providing expert resources to their banks' compliance teams, to ensure fair and well-informed representation of the line of business.

The trade compliance liaison role ought to be officially constituted, and should have the authority to represent the views of the trade team to compliance specialists, while being given a firm mandate to report on compliance requirements, gaps and processes in a structured manner. A casual approach to trade compliance will serve neither the trade team, nor the compliance objectives of the bank.

The ship needs to sail while the course is being set

A senior banker recently referred to their trade compliance challenges as stemming from a strong case of 'compliance mania', and indicated – only partly in jest – that the only way to assure full compliance was to 'turn off the lights and close the door behind us'. ➤

<i>Characteristic/Trend</i>	<i>Compliance</i>
Cross border, foreign counterparties	KYC & significant due diligence
High-risk, emerging markets	Political restrictions on trade banking; environmental compliance
Financially significant sums	Anti-money laundering, reporting
High reliance on complex IT	IT security, privacy issues
Outsourcing or offshoring of processes & technology	Cross border data transfer issues, KYC & due diligence
Impact of related regulatory & compliance requirements	Payments – regulatory requirements – SEPA (Single European Payment Area)

Compliance and trade services

► This view is not unique, nor is it limited to trade banking (or even banking in general). Large corporates have invested significant sums of money to assess and improve their preparedness for Sarbanes-Oxley audits, only to find that a 'pass' as interpreted by one audit team was rated a 'fail' by the formal audit, and similarly, that the levels of criticality of issues are often not clear.

Compliance specialists are navigating new waters, and the charts are being 'drawn' as business continues to move forward. Trade experts can help to identify actual, practical issues if they can collaborate closely with compliance specialists, and compliance teams must appreciate that business needs to continue to grow and evolve, even as the parameters and boundaries of compliance requirements are being defined.

While this may seem obvious and intuitive, the reality is that such relationship dynamics are given only limited attention, though they could prove critically important in terms of implementation and ongoing management of an effective compliance framework. Optimizing the process and the relationships makes financial sense as well, both in terms of the minimizing lost business (due to overly stringent compliance restrictions), as well as in terms of the costs involved in running compliance programs themselves. One financial services executive estimated that the annual cost of his company's SOX programme alone was in excess of \$30 million.

Similarly, the value of compliance advice in avoiding financial or other consequences of non-compliance cannot be overstated, and will only improve in quality as a compliance specialist becomes familiar with the trade business.

Specific examples

Trade is a business which involves foreign counterparties, often with limited access to information about such parties. One of the core value propositions of trade services and their product offering is to mitigate that lack of clarity through effective risk management (such as confirmation of export letters of credit) and efficient payment processes.

To what further extent, then, should a trade operations specialist be expected to conduct due diligence and KYC (know-your-client) investigations into a foreign exporter halfway across the globe in a low-technology emerging market? There are certainly sources, techniques and technologies today which make such an investigative process feasible; Can the local bank rely on (or leverage) the due diligence conducted by its presumably trusted correspondent bank on the overseas party? What processes can be put into place to achieve the goals of compliance while allowing the deal to be completed?

Whether the compliance requirement is reasonable or not is probably irrelevant at this early stage, since trade bankers will naturally wish to take the most conservative approach wherever feasible. The number of 'false positives' reported by trade banks to the US Treasury Department's Office of Foreign Assets Control is a reality that stems from a similar desire to avoid problems with compliance and regulatory authorities.

Will banks need to establish certain types of due diligence as an element of their correspondent relationships, and if so, how might such a model work to meet the varying compliance requirements in different jurisdictions? What will the implications be in terms of the agency relationships long recognized under UCP and in various legal traditions, as relates to documentary collections or letters of credit?

Can trade banks practically engage local experts in key markets to, assist in the conduct of this type of counterparty due diligence?

Decisions on the best approach ought to involve close consultation between trade experts and well-informed compliance specialists, to ensure that a solution strikes the right balance between compliance, cost, feasibility and business logic.

Trade operations outsourcing and offshoring both present compliance challenges which can potentially touch all elements of a trade services business, depending upon the degree to which business is outsourced. Given that this practice is gaining wider acceptance in trade banking, and that competitive pressures are likely to drive an increase in outsourcing activities, some focus ought to be directed at clarifying and defining the roles, responsibilities and exposures of partners in an in/outsourcing arrangement.

Can compliance requirements be defined, eventually, to a level of clarity which allows primary responsibility to remain with the outsourcer, or does some of the compliance burden automatically shift to the service provider, and if so, how will that shift be addressed, mitigated and compensated for?

Given that compliance, taken on a holistic level, covers both business and IT, it would appear that some in/outsourcing arrangements will automatically involve a shift in compliance burdens – if not at the outset, then almost certainly in the event of a finding of non-compliance and any ensuing legal action.

Do the specifics of such compliance requirements become integral to the contract between the banks?

To what extent can the carbon credits market provide a model for trade banks to 'trade' value based upon certain types of non-critical compliance gaps, particularly as compliance regimes will naturally evolve at different rates, and may provide some level of 'compliance arbitrage' opportunity which could be acceptable to the various regulatory authorities?

Strange notion, perhaps, but the intent is merely to illustrate that the boundaries and parameters of compliance are still very much in development, and that trade specialists are well advised to be intimately connected to the evolution of compliance in their banks, and in the industry as a whole.

Trade bankers, keep your compliance specialists close, so that you will not, in future, need to keep them closer! ■

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