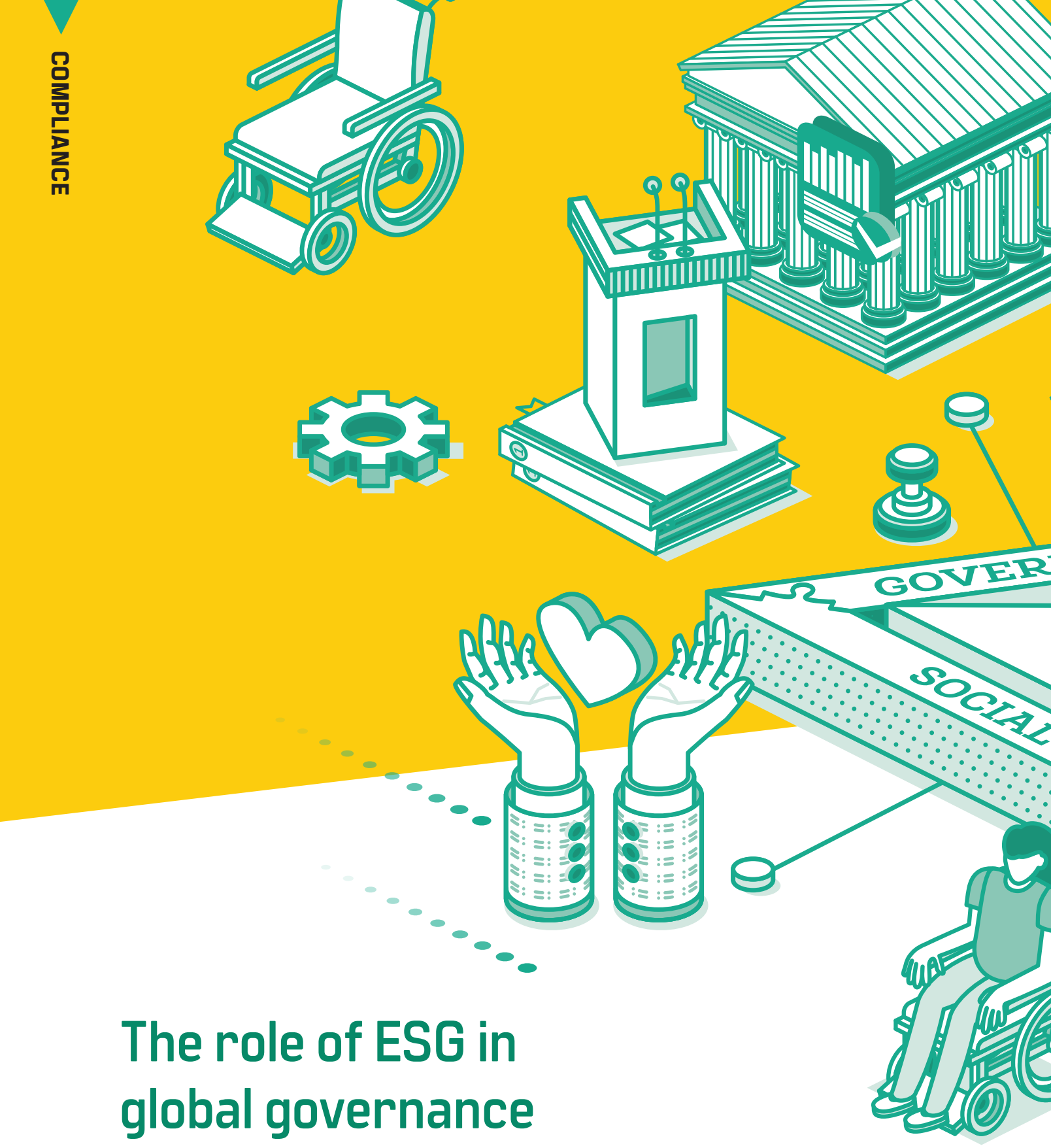


The role of ESG in global governance and the supply chain


NANCE
ENVIRONMENT
2020 2030 2040 2050
CO2

Environmental crime is one of the largest criminal activity sectors in the world. There are many kinds of environmental crimes, including illegal emissions into the air, discharge of substances into water or soil, illegal trade in wildlife or ozone-depleting substances, as well as illegal shipments or rubbish dumping. The illegal timber industry accounts for up to 90% of tropical deforestation in some countries and is worth approximately 152 billion dollars per year.[1] Serious crimes in this area often have a cross-border dimension that involves organised crime groups.

Human rights violations are increasingly connected to financial crime activity. There are 5.4 victims of modern slavery for every 1,000 people in the world. According to the latest report published by the International Labor Organization, an estimated 40.3 million victims are trapped in modern-day slavery. Of these, 24.9 million were exploited for labour, whilst 15.4 million were in forced marriage.[2] Besides being exposed to money laundering activities in relation to human trafficking or other human rights violations, financial institutions (FIs) may become implicated in human rights violations if, for example, finance is provided for a new dam which will lead to the forced relocation of indigenous people or if corporate funding is provided to a manufacturing company which has a reputation for compromising health and safety standards to maximize profits.

Many initiatives on the supranational, national and local levels are trying to find the answers to how these problems can be tackled to build a global green, clean and prosperous future by safeguarding the environment and the world's population from criminal activity.

This article will show how initiatives striving for more sustainability and good governance—of which anti-money laundering/combatting the financing of terrorism (AML/CFT) efforts are a part—have evolved and now connect on various levels. The integration of environmental, social and governance (ESG) into AML/CFT programs is an important element of this process and is discussed at greater length below; in addition to corporate supply chains and the nexus to trade-based money laundering. Customer due diligence frameworks are fundamental to the discussion on how a sustainable society and economy, based on true ethical standards, can be implemented and enacted globally.

Human rights violations are increasingly connected to financial crime activity

Global governance, sustainability, ESG and AML/CFT

Discussions around global governance have been catapulted to the top of government agendas in recent years, leading to the 2030 Agenda for Sustainable Development,[3] adopted by all UN member states and published in 2015. The agenda includes 17 Sustainable Development Goals (SDGs), setting the global agenda for sustainable development.

Although it is understood that the 17 SDGs are interconnected and need to be considered holistically, both from an integrity as well as from a reputational point of view, *SDG 16: Peace, Justice and Strong Institutions* is often the starting point for compliance professionals.[4] Given that anti-financial crime (AFC) efforts are essential to the success of any of the 2030 agenda's efforts, the topic of due diligence is of overarching importance across all SDGs and should be integrated into a broader set of principles to ensure the overall management of interconnected risk is performed in an effective manner.

The UN's SDGs are more encompassing in terms of scope and regulatory frameworks than the AML/CFT frameworks that have been in place since the 1980s, yet implementation and enforcement of the SDGs are lagging. Seven years have elapsed since the passing of the SDGs. In March 2021, the Financial Action Task Force's (FATF) President, Marcus Pleyer, criticised the gap between theory and reality when it comes to AML, stating that the structural weaknesses are why so many criminals continue to profit from the financial system, thus negatively impacting efforts to improve sustainability and good governance.[5]

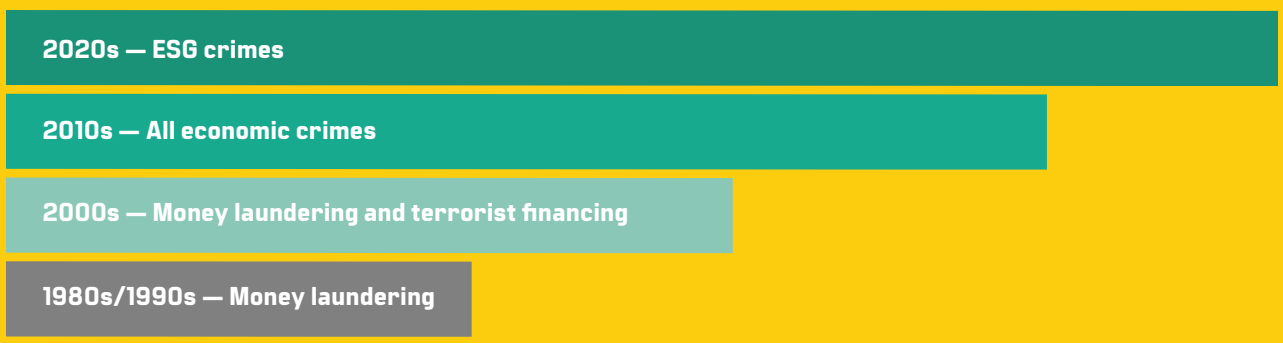
EU regulatory initiatives

Given this background, the EU included environmental crime and other social crimes as predicate offences under the EU Criminal Law Directive, which came into effect in December 2020.[6] The evolution of this regulatory framework from the 1980s to expand the focus areas of criminal activity are set in Chart 1.

In addition to AML/CFT regulations, European countries have enacted legislation to improve corporate transparency, paving the way to improve ESG standards across value chains globally. The enacted legislation affects mostly large corporations with thousands of employees. In 2021, Germany passed the Supply Chain Act, *Lieferkettengesetz* in German, sometimes also referred to as the Due Diligence Act, *Sorgfaltspflichtengesetz* in German. Like business partner due diligence, which initially affected only large corporations, the baton will be passed down to the smaller companies within the supply chain that will be forced, as a result of regulatory obligations affecting larger corporations, to ensure that they are also compliant in terms of their supply chain due diligence.

On 23 February 2022, the European Commission adopted a proposal for a directive on corporate sustainability due diligence impacting all EU member states and a much wider range of companies.[7] The proposal will be presented to the European Parliament and the European Council for approval. Once adopted, member states will have two years to transpose the directive into national law and communicate the relevant texts to the commission.

Chart 1: ESG and AML/CFT framework



The new due diligence rules will apply to all EU-registered companies as follows. Non-EU companies active in the EU with turnover threshold aligned with the following are also in the directive's scope.

- EU limited liability companies of substantial size and economic power with over 500 employees and over 150 million euros in net turnover worldwide will be in the directive's scope.
- Other limited liability companies operating in defined high impact sectors that do not meet the thresholds above but have more than 250 employees and a net turnover of 40 million euros or more worldwide will also be in the scope. For these companies, rules will start to apply two years after those of the larger companies listed above.

Corporate risk management

Due diligence is a common concept in all corporate risk management frameworks. The idea of corporate human rights due diligence (HRDD) is set out in the UN's *Guiding Principles on Business and Human Rights*.[8] HRDD obligations refer to a company's duty to carry out ongoing risk management to determine if its business practices could potentially adversely affect human rights. This includes assessing all risks which could result from a corporation's actions on employees, consumers and persons who could be affected by environmental harm.

The aim is to ensure that companies are not exposed to activities that can significantly harm any environmental or social objective and that their business partners, on which due diligence is being conducted, follow good governance practices. This requires a holistic approach.

Given the evolution of regulatory frameworks, which now include ESG elements, such as human rights and environmental crimes and other financial crimes, corporations and FIs are obliged to extend their scope of research and map out all direct and indirect risks across their business relationships. Therefore, AML/CFT due diligence and supply chain due diligence are closely linked, most apparently via typologies around trade-based money laundering.

Trade-based money laundering and supply chain due diligence

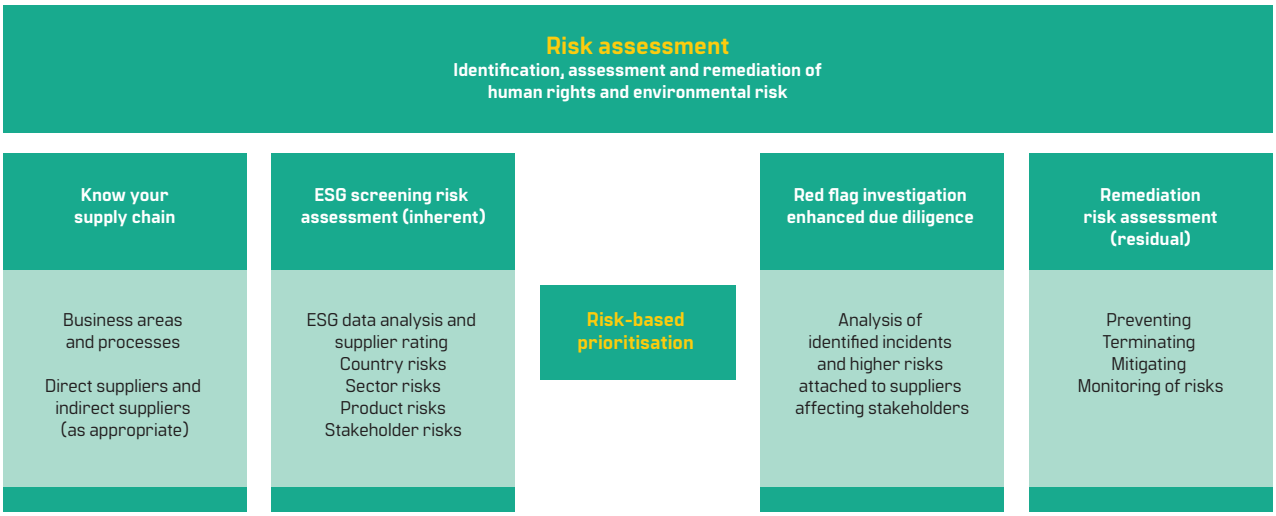
Trade flows provide ample channels through which transactions can be obscured due to the presence of complex transactional structures, for example, foreign exchange transactions, trade finance and the commingling of illicit funds with cash flows of a legitimate business. International trade flows also offer multiple opportunities for criminal organisations to transfer value across borders. According to FATF's typology report,[9] some of the basic techniques used in trade-based money laundering include:

- Over- and under-invoicing of goods and services
- Multiple invoicing of goods and services
- Over- and under-shipment of goods and services
- Falsely described goods and services

FATF published a series of useful risk indicators for trade-based money laundering in 2021, outlining a wide range of red flags which can be indicative of financial crime activity.[10] Given that laundered funds can infiltrate legitimate supply chains, trade-based money laundering red flag indicators can provide some useful insights into ESG crimes across supply chains and to further support in the development of relevant typologies. See also ACAMS' White Paper on ESG for a selection of case studies.[11]

To meet the requirements of the all-crime approach to AML/CFT regulations, as well as upcoming legislation, due diligence and risk assessment methodologies will require a more intelligence-led approach to effectively meet these new challenges. A model for the implementation and/or integration of human rights and environmental risks into the due diligence process is exemplified in Chart 2.

Chart 2: Integrating human rights and environmental risks to the due diligence process



Outlook

Global challenges call for a new approach to managing financial crime risk. Although there is a common understanding that this must be risk-based, there is a growing consensus among thought leaders that this new approach must be both intelligence-led and informed by human judgement. Whilst human analysis remains fundamental to ensuring effective risk management—a tech stack, which operates with high-quality data and smart technology—must be part of the program. Due diligence methodologies, therefore, need to be revised and adapted to fit this purpose.

The quality of due diligence efforts, both internal and external, will define the effectiveness of any AML/CFT compliance program. Analysts who are experts in the field of research—when armed with the best sources of information and technology—are well-placed to make sense of the key risks and, more importantly, to identify those high-risk areas that warrant more in-depth attention and monitoring. Thus, also supporting their organisations in effectively managing their reputational risk exposure at a more strategic level, as well as optimising the use of resources.

Although this is starting to happen, many businesses operating across supply chains are not in a position to recognise signs of trade-based money laundering. Therefore, increased awareness through public-private partnerships and between the corporate and financial sectors will be important to identify cases of trade-based money laundering that can subsequently be investigated by law enforcement authorities and thereby ensure a more transparent and ethical supply chain management that is in line with ESG standards. AT

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