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Navigating the Intersection of ESG and Money Laundering: How Financial Institutions Can Prevent Environmental Crime

Environmental protection laws have been in place in many countries for more than 50 years.[1,2] The United Nations Environment Programme (UNEP) and the International Criminal Police Organisation (Interpol) have highlighted the rise of environmental crime, its links to bribery and corruption, and its devastating impact on environments globally.[3] But despite the strong connection to money laundering and the resources governments, law enforcement and financial institutions have devoted to financial crime prevention and detection, environmental crime has largely stayed below the radar. The focus on environmental, social and governance (ESG) commitments by regulators and governments will likely be a catalyst for making it a priority.

With COP26[4] advancing a globally coordinated effort to achieve net zero by 2050 and regulators sharpening their focus on the ESG agenda, financial institutions have become increasingly invested in developing ESG strategies. A key part of their agenda is limiting the ability of individuals and organisations to benefit from activities that adversely impact the climate. These activities include environmental crimes such as illegal logging, illegal wildlife trade and waste trafficking.

[1] "Historical Development of Environmental Criminal Law," U.S. Department of Justice, www.justice.gov/enrd/about-division/historical-development-environmental-criminal-law#:~:text=These%20cases%2C%20together%20with%20others,to%20extinction%20of%20entire%20species.

[2] "Dramatic Growth in Laws to Protect Environment, but Widespread Failure to Enforce, Finds Report," UN Environment Programme, January 24, 2019, www.unep.org/news-and-stories/press-release/dramatic-growth-laws-protect-environment-widespread-failure-enforce.

[3] "The Rise of Environmental Crime: A Growing Threat to Natural Resources Peace, Development and Security," UN Environment Programme, www.unep.org/resources/report/rise-environmental-crime-growing-threat-natural-resources-peace-development-and.

[4] UN Climate Change Conference UK 2021, https://ukcop26.org.

Environmental crimes generate around $110 to $281 billion annually,[5] ranking as the fourth-largest criminal activity globally after drugs, counterfeiting and human trafficking[6] and prompting widespread attempts by perpetrators to launder the proceeds through financial institutions. This relationship between environmental crime and money laundering creates an imperative for financial institutions to establish environmental crime as a factor in their ESG frameworks and risk management practices that will be ultimately applied to their clients and suppliers.

Below, we provide an overview of environmental crime and recommend actions financial institutions can take to integrate detection and prevention strategies in their ESG and financial crime frameworks.

What is environmental crime?

There is currently no universal definition for *environmental crime*,[7] or *ecocide* (i.e., the destruction of the natural environment by deliberate or negligent human actions such as deep-sea bottom trawling, oil spills, overfishing, deep-sea mining, deforestation, and land and water contamination[8]).

In a 2021 report, the Financial Action Task Force (FATF) provided an overview of the key types of environmental crime, typologies and vulnerabilities.[9] The report covers a wide range of criminal activities but focuses specifically on illegal waste trafficking, forestry and mining, which account for up to two-thirds of all proceeds from environmental crimes. These activities can have extensive implications for the environment, the economy, and public health and safety.

[5] "Environmental Crime," Financial Action Task Force, www.fatf-gafi.org/publications/environmentalcrime/environmental-crime.html?hf=10&b=0&s=desc(fatf_releasedate).

[6] "The Rise of Environmental Crime: A Growing Threat to Natural Resources Peace, Development and Security," UN Environment Programme, www.unep.org/resources/report/rise-environmental-crime-growing-threat-natural-resources-peace-development-and.

[7] "Money Laundering From Environmental Crime," Financial Action Task Force, July 2021, www.fatf-gafi.org/media/fatf/documents/reports/Money-Laundering-from-Environmental-Crime.pdf.

[8] "What Is Ecocide? Definition and Examples," by Rebecca Clarke, June 30, 2021, Treehugger.com, https://www.treehugger.com/what-is-ecocide-definition-and-examples-5188053.

[9] "Money Laundering From Environmental Crime."

Representative Environmental Crimes[10]

Illegal logging: Harvesting, processing, transporting, buying or selling of timber in contravention of domestic and international laws.

Illegal land clearing: Illegal acquisition and clearing of land for farming, building or real estate speculation.

Forestry crime: Criminal activity in the forestry sector covering the entire supply chain, from harvest and transportation to processing and selling, including illegal logging and land clearance.

Illegal mining: Mining activity undertaken without state permission or with state permission obtained through corruption.

Waste trafficking: Illegal export and/or illicit disposal of electronic waste (e-waste), plastics and hazardous substances.

The FATF recognises other environmental crimes, including **illegal, unregulated and unreported fishing and **illegal carbon trading**.*

The FATF notes that while contributors to the lack of awareness and prioritisation of environmental crime among major economies vary geographically, they generally include:

- Non-standardised definitions.
- Very general or, alternatively, specific nature of environmental offenses.
- Limited coordination between anti-money laundering and counter-terrorist financing authorities.
- Insufficient powers or resources for law enforcement to investigate and trace proceeds.

In many cases, there is an overlap between environmental crime and social crimes. For example, illegal mining or mineral extraction/processing (e.g., blood diamonds) often entails inhumane or dangerous working conditions, and trafficking and wildlife trafficking can follow the same trade routes.[11] Though these social issues have generated attention, an emphasis on environmental crime prevention and detection would raise their visibility further.

What do financial institutions need from lawmakers and regulators? Like major economies, the financial services industry has not focused on environmental crime historically. (However, many financial institutions were signatories to voluntary and charitable initiatives such as the United for Wildlife Financial Taskforce, which was set up in 2019.[12]) To develop environmental crime frameworks, financial institutions will look to governments, law enforcement and regulators to:

10 "Environmental Crime," Financial Action Task Force.

11 "Environmental Crime," Interpol, www.interpol.int/Crimes/Environmental-crime.

12 "Environmental Crime," Financial Action Task Force.

- Consider environmental crime in their national or sectoral money laundering risk assessments and embed it within supervisory frameworks and expectations. (Some countries, such as the U.S., already conduct this exercise, though without evidence of enforcement.)
- Publicise actions taken to investigate and prosecute environmental crime domestically and internationally.
- Publish environmental crime typologies to enable appropriate monitoring.
- Emphasise environmental crime prevention in ESG framework guidance.

In addition, financial institutions will seek to ensure that environmental crime risks are thoroughly covered by media screening providers.

Incorporating environmental crime into risk frameworks

Environmental crime needs to be identified and addressed in all aspects of a financial institution's financial crime and ESG frameworks. In the following sections, we provide practical considerations for approaching the integration of environmental crime in existing risk frameworks.

ESG frameworks considerations

- **Management oversight:** Boards of directors and risk committees will want to review and approve risk appetites and criteria for customer acceptance. This process will include assessing the impact on the institution's capital and financial crime risk relative to the revenue potential, and the impact on ESG commitments and regulatory requirements more widely. Management needs to receive detailed reports relating to certain higher-risk sectors (e.g., mining, forestry) and countries (i.e., those most closely linked to categories of environmental crime) so that risk profiles can be reviewed and managed on an ongoing basis.
- **Risk appetite and client acceptance:** Beyond suspected environmental crimes, institutions will need to consider ESG strategy and reputational risk in their decisions about customers. This consideration includes industries or customers whose activities are not illegal but may be beyond the institution's ESG risk appetites or perceived by the public to promote environmental crime or ecocide (e.g., significant polluters and generators of greenhouse gas emissions, and consumers of energy for limited economic gains, such as cryptocurrency miners). Greater reporting and disclosures on climate-related risks, particularly in certain sectors and countries, will help inform decisions.
- **Customer supply chains:** ESG requirements and disclosures demand an understanding of a third party's supply chain management, particularly for Scope 3, or value chain,

emissions.[13] This insight will also be needed to assess the risk that a customer is dealing with parties involved in environmental crime. While this type of due diligence requires detailed information and verification of the nature of the customer's business, transactions and activities, the information it provides will be valuable for both ESG and financial crime risk assessments.

- **Customer contact and information gathering:** ESG will require significant amounts of information and disclosures from clients, suppliers and other third parties. To improve the customer experience and enable complete information for decision-making, institutions will seek to consolidate the data collection and checks process, reflecting on questions including:
  - What are the most effective ways to obtain the information needed for ESG and financial crime assessments while maintaining a good customer experience?
  - Can the same customer contact be leveraged to deliver customer service and gather information — at onboarding and periodically, to conduct reviews and receive updates?

  Additionally, information gathered from transaction monitoring reviews, patterns of transactions or understanding of specific transactions might be valuable in ESG reviews and considerations.

Financial crime framework considerations

- **Management oversight, reporting and information:** Senior management plays a key part in the operation of financial crime frameworks. Management should set risk appetite, challenge and oversee the control measures that have been implemented, and receive appropriate management information and metrics. Where required, additional resources may need to be approved by management to include environmental crime as a new and emerging area of the financial crime framework. Management will also be well positioned to consider the alignment of environmental crime with the ESG framework.
- **Risk appetite statement and financial crime enterprisewide risk assessment (EWRA):** A fundamental element of any financial crime framework is defining risk appetite. The importance of this exercise is particularly true for crimes with an environmental nexus. Because environmental crime impacts ESG and financial crime risk appetites, institutions should ensure their ESG and financial crime risk appetites are appropriately aligned as they establish their ESG risk appetite. (The same alignment will be necessary if the risk from legitimate business is too high from a reputational or ESG perspective.) The institution's money laundering reporting officer should work with the head of sustainability and the head of risk to develop a consistent and detailed risk appetite statement, underpinned by a description of intended outcomes, metrics and risk indicators

[13] "Scope 3 Inventory Guidance," U.S. Environmental Protection Agency, www.epa.gov/climateleadership/scope-3-inventory-guidance.

and tolerances. This risk appetite statement, like others, should be reviewed and approved by senior management.

The EWRA process should also consider environmental crimes within the identification and assessment of risks. The inclusion of environmental crimes within governments' national risk assessments will enable specific and detailed consideration of the impacts on institutions' existing and target customers, markets and product sets that will support a risk-based approach to financial crime compliance.

- **Customer risk-rating methodology:** An appropriate risk-rating methodology that includes all relevant financial crime risk factors is critical to any successful control framework. Institutions will have well-established methodologies that cover the financial crime risks related to countries or geographies, customers, and products and services. Some of the issues that will need to be considered and incorporated into these risk criteria include:

    - *Country risk*: Environmental crime may originate in countries rich in natural resources, including forestry products, minerals and wildlife.[14] In addition, developing countries may have less stringent laws and protections than developed countries and, as a result, be inherently more at risk of environmental crime. Another risk factor may be operations in and around active conflict zones, as environmental crimes can be used to fund conflict.

      Each institution will need to risk-rate countries and incorporate the increase in risk into country or geographic risk assessments, including for a customer's base of operations, its supply chain and transactions from which payments may originate.

    - *Customer risk*: Certain features of environmental crime, including the use of front companies and shell companies by perpetrators to hide beneficial ownership and foreign politically exposed persons (PEPs) involved in the corporate or ownership structure, may significantly increase customer risk.[15] The use of unnecessarily complex or opaque legal structures would all be higher risk factors for financial institutions but a combination of these risks, particularly where PEPs are involved, may indicate a higher environmental crime risk and should be assessed.

    - *Products and services risk*: Criminals rely on trade-based fraud to perpetuate environmental crime.[16] As such, trade finance business is likely to be at higher risk of being used for environmental crime money laundering. Institutions will need to consider additional environmental crime risks arising from these services, given the complex nature and volume of transactions and the use of false descriptions and overdeclaration or underdeclaration of goods being shipped. Institutions may also consider the risk assessments for correspondent banking, particularly for those correspondent banks based in higher-risk countries.

[14] "Environmental Crime," Financial Action Task Force.

[15] Ibid.

[16] Ibid.

In addition, there may be certain products that present a high risk of environmental crime. Institutions may decide, under a risk-based approach, to avoid business within the sectors from which those products originate. An example is the illegal gold mining industry in the Central African Republic,[17] which many financial institutions refuse to trade with for social reasons.

- **Customer due diligence (CDD) and enhanced due diligence (EDD) requirements:** Once risk appetite and customer risk assessments have been determined, institutions will be considering how to mitigate the risk of environmental crime in their CDD procedures. As with other financial crimes, this process is likely to entail a combination of prescribing required documentation to evidence the nature of the customer's business, the legal entity structure and beneficial ownership, and the expected nature and extent of transactions. Public registers, where available, will also be a valuable source of information. Client site visits supplemented by local knowledge of the reputation of the client and suspected links to criminal activity will provide additional insights. Similarly, it will be important to verify sources of funds and wealth.
- **Ongoing monitoring and periodic reviews:** Periodic reviews remain a key element of a financial crime control framework, particularly when it is likely that, over time, legislation will be enacted to introduce new categories of environmental crime. The FATF affirms that the mixing of legal and illegal activities can often occur in industries susceptible to environmental crime, and this trend may develop over time. It will be important for institutions to update all required customer information, update their knowledge of customers' business, activities and size, and ensure that these reviews feed into transaction monitoring to identify suspicious activity.
- **Screening:** The risk of environmental crime increases with the involvement of PEPs. As such, the need to identify foreign PEPs, particularly those in higher-risk countries and government functions, will highlight the need for a risk-based approach to screening customer and related parties regularly. Adverse media screening of environmental crime risk indicators for the company, beneficial owners or directors will be helpful to identify applications that require further investigation. Some local knowledge may be needed to clarify whether there are grounds for concern. Because environmental crime is often perpetrated through bribery of government officials, adverse media screening of bribery and corruption allegations may be another key assessment.
- **Transaction monitoring:** Criminals will have taken steps to evade detection in, and many crimes may occur in, countries with limited documentation or available public sources for verification at the onboarding stage, making transaction monitoring one of the most effective ways to expose suspicious activities and prevent environmental crime. This exercise will include the detection of unusual patterns of transactions or levels of profitability and

[17] "Organized Environmental Crime: Why It Matters for Peace Operations," by Dr. Marina Caparini, Stockholm International Peace Research Institute, May 12, 2022, www.sipri.org/commentary/topical-backgrounder/2022/organized-environmental-crime-why-it-matters-peace-operations.

activity compared to peers. The FATF points out that environmental crime risk indicators include:

- The nature, origins or destination of transactions and cash flows.
- Unusual or unexplained increases in economic activity.
- Customers' activities.
- PEP involvement.
- Activities with licenses, permits or other rights to natural resources, particularly near conflict areas.

Another channel for environmental crime highlighted by FATF is third-party wire transfers. Institutions will want to ensure that appropriate action is taken to allow third-party transfers or payments from certain accounts on an exceptional basis, particularly for higher-risk customers.

Institutions should assess how best to identify these risk indicators as they apply to their customer base and enterprisewide risk assessment, as well as how best to calibrate their transaction monitoring systems to identify them.

Policies and procedures

Institutions will need to review and update policies and procedures and revise systems guidance and manuals to reflect all changes that are required and establish additional documentation needs and risk assessments that must be conducted and evidenced.

Training and awareness

A number of regulators have highlighted the need for ESG training of staff and the avoidance of "competence washing."[18] Institutions already have in place training programs that cover AML and broader financial crime arrangements appropriate to the role of staff. These programs will need to be amended to highlight the links between ESG and the prevention of environmental crime, details on the origins of environmental crime, risk indicators, and controls for identification and reporting. In some cases, training of staff using local knowledge and examples will be helpful. Given the expected increase in focus on determining what is acceptable from an environmental crime and ESG risk appetite perspective, frequent training (i.e., at least annually) will likely be necessary.

[18] "*A Strategy For Positive Change: Our ESG Priorities*," Financial Conduct Authority, June 29, 2022, www.fca.org.uk/publications/corporate-documents/strategy-positive-change-our-esg-priorities.

What can financial institutions do now?

Institutions should keep the following points in mind as they advance environmental crime detection and prevention programs:

- Be proactive. Institutions should be starting the process of integrating environmental crime considerations across their organisation's risk structures. Institutions that take action to define and gather the information and assessments required will be positioned to integrate certain requirements into periodic reviews rather than needing to conduct one-off exercises to obtain information.
- Collaborate and share knowledge with other institutions. Work together at an industry level to produce guidance.
- Help law enforcement better understand the origins and methods for committing environmental crime by making Suspicious Activity Reports that reveal industry and country vulnerabilities and facilitate typologies.

Conclusion

Though environmental crime has historically lacked focus, the ESG agenda has raised its profile. As with *ESG*, the definition of *environmental crime* will evolve over time, bringing more clarity to business decisions. To shape its evolution, financial institutions have an immediate responsibility to include environmental crime risks in their ESG and financial crime frameworks. Acting now will deliver considerable benefits to the financial services industry and, ultimately, to society.

About Protiviti's Financial Crime and ESG Practices

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

Protiviti's ESG practice offers expertise and support across multiple ESG topics, using our ESG framework outlining challenges, risks and opportunities, and stakeholder impacts. Our ESG framework informs our approach to helping institutions and enables a holistic approach tailored to institution-specific requirements. Protiviti's ESG practice can support institutions with ESG assessments, including ESG frameworks, ESG data management, ESG internal controls and ESG capability maturity assessments.

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