



BENJAMIN HILGENSTOCK, ELINA RIBAKOVA, AND ANNA VLASYUK

Russian imports of battle-eld goods that are subject to export controls, including from Western producers, have surged since mid-2022 and reached levels close to those prior to Russia's full-scale invasion of Ukraine. Russia thus continues to be able to acquire critical foreign components that it needs for its military industry. These imports occur via mainland China, Hong Kong, Turkey and the United Arab Emirates, while other countries including Armenia, Georgia, Kazakhstan and the Kyrgyz Republic have also seen massive increases in imports from the EU and other coalition countries that likely end up in Russia. The implementation and enforcement of export controls faces major challenges, which are multifaceted and centre around complex supply chains, lack of transparency in documentation and opaque financial structures. The issues are familiar from anti-money laundering (AML) and countering financing of terrorism (CFT) frameworks, where much progress has been made in the last two decades. A similar approach could help in rendering export controls effective. We propose First, financial institutions could be tasked to play a role in the monitoring of the trade in export-controlled goods and the blocking of illicit transactions, building on their experience with due diligence in financial transactions. Second, non-financial companies could learn from banks' efforts in the AML/CFT sphere to implement proper due-diligence procedures and to ensure export controls compliance. Public-sector investigations and appropriate fines are critical to increase the incentives for firms to act. Technology sanctions are going to be part of the economic statecraft toolbox for the foreseeable future. The Russia case will test their effectiveness and credibility, or lack thereof.

Benjamin Hilgenstock is a Senior Economist at KSE Institute

Elina Ribakova (elina.ribakova@bruegel.org) is a Non-resident Fellow at Bruegel

Anna Vlasyuk is a Legal Research Fellow at

1 Export controls a new frontier in economic statecraft

Export controls played an important role in the Cold War when Western allies (e.g. 20.003Bd (n(

Moreover, we argue that Western firms producing sanctioned goods should face greater obligations to monitor and restrict their distribution networks to ensure compliance with export restrictions.

2 The Russian case: challenges of export control implementation

Given the complexity of the February 2022 export controls regime, the lack of experience, especially in Europe, and the limited resources of the Russian government, the implementation of these controls is a significant challenge. The Russian government has implemented a series of export control measures, including a ban on the export of dual-use goods to Russia and a ban on the export of certain technologies to the United States. These measures have led to a significant increase in the cost of doing business for Western companies in Russia and have also led to a significant increase in the cost of doing business for Russian companies in the United States.

Figure 1: Russian imports of battle eld goods

Source: KSE Institute

Russia can thus acquire critical inputs that its economy and military industry require by using producers in China and other countries that have stepped in and replaced suppliers from coalition

Republic whose trade with Russia is not fully reflected in the data underlying Figure 1 from the coalition, in particular the EU, to these three countries have risen sharply, coinciding with the imposition of export controls on Russia²⁰ (Figure 4)

Figure 2: Flows of battle-related goods to Russia in 2023

Figure 4 Exports to Armenia, Georgia, Kazakhstan and the Kyrgyz Republic, \$ million

Sources: International Monetary Fund. Notes: Other includes Australia, Canada, Japan, New Zealand, Norway, Singapore, South Korea, and the United States.

Figure 5: Russian imports of battle goods in 2023 by producer, \$ million

Source: KSE Institute

Effective enforcement of export restrictions can be achieved without the private sector doing its part

3 The financial system's role in improving export controls

To improve implementation and enforcement of the export controls regime, ~~against~~ Russia safeguard the credibility of technology sanctions, we propose to leverage the financial system's critical role in international trade and law in its considerable experience with due diligence efforts related to financial transactions.

First, financial institutions could be tasked to play a key role in the monitoring of trade in export controlled goods and impedin illicit transactions. Export controls enforcement faces similar challenges to anti-money laundering and countering financing of terrorism (AMLCFT): complex chains of custody, opaque ownership structures, frequent institutional changes, reliance on less jurisdictions for the sake of circumvention schemes, and often highly fungible goods. Because of the regulatory framework that has been established in the past two decades in these areas, financial institutions have already built internal compliance architecture to detect such. While some modifications to the legal framework and internal procedures may be required to apply existing AMLCFT regulations to the sanctions sphere, banks fundamentally have access to much of the information needed to trace their export-controlled goods and the experience and resources to use it. We explain below in more detail how this can be done but, intuitively, the continued dominance of banks from coalition countries within the global financial system should enable them to trace the corresponding financial transactions to many physical shipments of export-controlled goods.

Second, non-financial companies can learn from banks' efforts in the AMLCFT sphere to implement proper due diligence procedures and ensure compliance with export control [TJ/(w)-2 ()10 (t)-/5 (w)8 ()2 0.

business activities of counterparties is exactly what is needed for banks and financial companies as they undertake the kind of due diligence that we propose. Courts have not go

is not the case for sanctions legislation. It provides guidance on identifying trust ownership and allows EU countries to set even lower thresholds for the purpose of identifying ownership.

3.1.3 Expanding access to critical information for export controls enforcement

When it comes to the issue of export controls enforcement, a major problem is that banks may not have the information needed to screen for potentially problematic counterparties. While export controls implementation requires specific illicit transactions, banks may have access to this information, in other cases, they do not at this point. For instance, there is an important distinction between an involvement in trade finance and the execution of cross-border transactions. In the case of the former, trade finance agreements contain a wealth of information, including on entities and the specific goods banks need to determine if export controlled items are traded and/or red flags appear for any of the entities involved. In the case of the latter, banks do not have information on the specific goods that are part of a transaction. They can only do a basic screening of the transfer's recipient.

Changes to the legal framework are needed to put financial institutions in a position to properly play the role that we are proposing. Mandatory disclosure of information on cross-border transactions, including when executed via the SWIFT (Society for Worldwide Financial Telecommunications) financial messaging system. For instance, a description of goods and/or services is currently optional in the case of letters of credit in trade. This is a significant barrier for banks. While they have the legal right to request additional information from the parties involved in a transaction, the inability to determine whether goods are controlled makes it difficult to determine in which cases this should be done. Given the large number of cross-border transfers that banks carry out daily, this is a major practical limitation. A related issue is that export controls, insofar as they are based on dual goods lists, have only recently begun to include specific nomenclature codes (Harmonized System or HS codes) well a critical step towards better implementation.

3.1.4 Providing clear guidance and moving towards a risk-based system

The current financial sanctions regime is far from a risk-based approach. Financial institutions face such a wide range of regulatory requirements (AML/CFT to sanctions) that they are often not able to properly prioritize tasks. Instead, this leads to the fulfillment of formal legal requirements without too much consideration given to national security considerations. Ultimately, this is the result of a lack of coordination between government agencies engaged in sanctions enforcement (eg OFAC and FinCEN) and financial industry supervisors. For banks to be able to help enforce export controls, they have to be provided with specific guidance that not only clearly outlines regulatory requirements

a problem in terms of the cost of compliance, they can actually significantly reduce the overall effectiveness of the industry's involvement in AML, CFT and sanctions implementation.

Clear guidance is particularly important when it comes to smaller sized institutions, which do not have the same resources for compliance efforts but actually play a major role with regard to trade finance. To enable them to implement export related diligence procedures, it is necessary to do more than simply define additional regulatory requirements. Instead, authorities need to work with the industry, including trade associations to develop systems that work for different players in the financial sector from global banks to smaller institutions. Again, the focus has to be on creating an effective system that delivers results rather than simply increasing the regulatory burden. Ultimately, leveraging the role of banks to improve export controls enforcement will require government agencies and the private sector to cooperate closely.

3.2 Empowering the corporate sector by applying lessons from the financial system

The involvement of financial companies is crucial for better implementation and enforcement of sanctions and export controls. Companies from sanctioning countries continue to account for a substantial share of the priority battle field items that reach Russia (46 percent in value terms in 2023). As these goods are overwhelmingly manufactured in third countries (61 percent) and shipped to Russia from there (83 percent), thus, likely never physically pass through coalition jurisdictions, compliance efforts must start with resellers that are incorporated in sanctioning countries. After the initial sales, it becomes increasingly challenging, if not impossible, to monitor supply chains and to impede transactions. In practice, this means that companies need to implement procedures to identify

re-export to Russia. This clearly defines the due diligence requirements EU based companies in their dealings with export controlled goods and properly implemented, can also have a significant deterrent effect on EU entities.

Annex 1 AML/CFT Regulations in major jurisdictions and their weaknesses

national authorities verify the accuracy and completeness of information submitted, it is updated, requiring also probably a upgrade in public sector monitoring.

In addition, there are loopholes regarding the recording of companies active in the EU but domiciled elsewhere. While in the US disclosure for all companies active in the US is obligatory, EU requirements only apply to entities that are incorporated in a member state. Similarly, in the trust register, member states need to record trusts from third countries but only if they have a real estate or started a new business activity in the EU since 2020, and the real estate registry only covers legal rather than beneficial ownership and there is currently no unified registry or proposal to establish one. Finally, member state bank account registries do not record other financial assets such as securities or cryptocurrency and no interconnection on the EU level has been implemented. Stricter requirements on the recording of companies active in the EU appears necessary and warranted – not only as regards export controls but also when it comes to geoeconomic risks from third countries.

Recognising these weaknesses, the European Commission, in 2021, presented a new package of proposals to harmonize AML/CFT rules across the union with a focus on better information exchange and to establish a new EU authority to address money laundering enforcement challenges related to Russia sanctions, it is critical that these proposals are advanced quickly. In particular, beneficial ownership registries play an indispensable practical role in the enforcement of sanctions

United States On 1 January 2021, the US Congress passed the Corporate Transparency Act (CTA) (16 U.S.C. § 3231(a)(1) (r)8 eS(t)11 o(bh)6 eS s36 unit-95

request beneficial ownership information with the customer's permission to implement FinCEN's 2016 customer diligence rule and to comply with "any legal requirement or prohibition designed to counter money laundering or the financing of terrorism, or to safeguard the national security of the United States, to comply with which it is reasonably necessary for a financial institution to obtain or verify beneficial ownership information of a legal entity customer"

United Kingdom The most pressing issue in the UK context is corporate transparency, the lack of it – in British Overseas Territories and Crown Dependencies. The UK has bilateral agreements with these jurisdictions on the sharing of beneficial ownership information since 2017. In addition, the Sanctions and Anti-Money Laundering Act 2018 required public registers to be established in Overseas Territories by 31 December 2020, but the deadline was later postponed to the end of 2023. Similarly, Crown Dependencies were to launch such registers at the same time. This, however, did not fully materialise. For the time being, beneficial ownership information from British Overseas Territories and Crown Dependencies

response to Russia's full-scale invasion of Ukraine, it also introduced legislation establishing a register of overseas entities owning UK property, and the register was activated in August 2022.



© Bruegel 2024. All rights reserved. Short sections, not to exceed two paragraphs, may be quoted in the original language without explicit permission provided that the source is acknowledged. Opinions expressed in this publication are those of the author(s) alone.

Bruegel, Rue de la Charité 33, B-1210 Brussels
(+32) 2 227 4210
info@bruegel.org
www.bruegel.org