Dual threat dual defense

Why ESG is the key to effective bank compliance

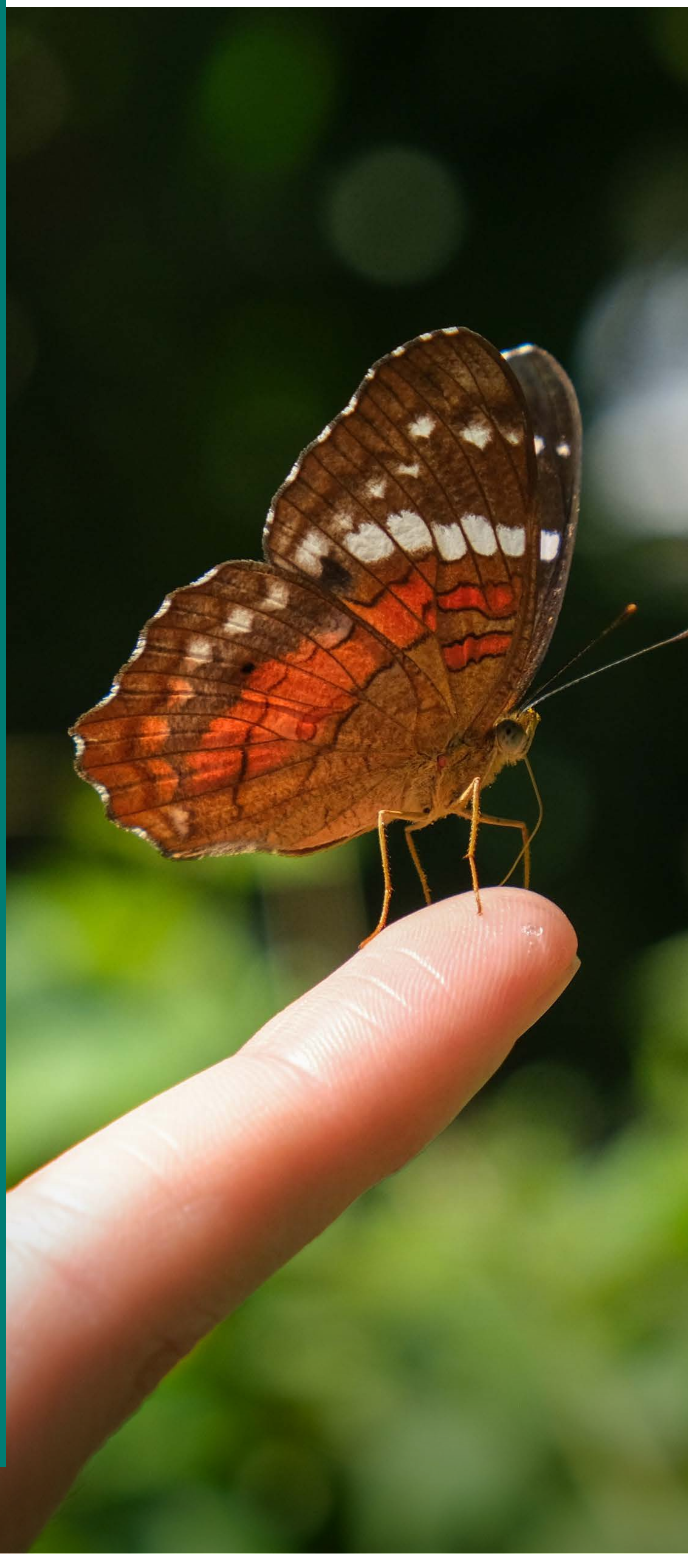
Capgemini

A synergistic approach to safer sustainable banking

Today, many financial institutions track environmental, social, and governance (ESG) factors to better understand the organizations they do business with. They do so for a variety of reasons—to reduce risk from issues such as climate change and scandal; to gauge the potential financial performance of client or supplier companies; to guide customers looking for sustainable finance or responsible investments; to manage their own carbon footprint; and to comply with increasing ESG-related regulatory requirements. At the same time, institutions put a great deal of effort into financial crime compliance (FCC), and meeting the standards and regulations established by the U.S Treasury Department's Financial Crime Enforcement Network (FinCEN) and other governmental bodies. These FCC operations aim to reduce money laundering and protect the financial system from the flow of illicit funds.

> *There's a consensus that ESG considerations should be incorporated into the client prospect evaluation stage. This ensures that reputational risk is addressed upfront, prior to onboarding and KYC processes.*
>
> **Business Executive, major UK bank**

Both ESG and FCC screening are important for all financial institutions. These two critical activities have traditionally operated as separate domains, each in its own silo pursuing its own mission. But there is an untapped potential to leverage ESG considerations in FCC, using technology to combine the strengths of both domains. By doing so, institutions can significantly enhance their efforts to proactively uncover and combat illicit activities and reduce their own risk of being associated with crime and running afoul of regulators.



The link between ESG and FCC

In their FCC operations, financial institutions focus on Know Your Customer (KYC) efforts that aim to understand the customer's business and any associated criminal risks. KYC looks largely at financial transactions, money flows, and periodic negative screenings to identify potential problems. On the other hand, ESG screening looks at a range of news reports and publicly available information to develop insights into a corporation or its associated parties' commitment to ethical behavior and responsible practices.

Although they focus on different domains, these areas are closely related since bad ESG behavior can involve predicate crimes that lead to money laundering charges for the responsible parties. For example, companies using illegal mining or logging practices that lead to environmental harm will want to hide the money earned in their operations. So too will those involved in unethical social behaviors, such as human trafficking or the use of child labor. In addition, companies with weak governance structures are more susceptible to bribery and corruption, which are associated with embezzlement and fraud.

ESG risks are often not factored into the risk rating during onboarding and KYC processes. However, some banks incorporate ESG checks through adverse media searches during a customer refresh. Policy updates may be necessary to formalize the inclusion of ESG considerations in risk assessments.

Compliance Executive, global bank

The impact of ESG-related financial crimes is profound. Indeed, environmental crime and human trafficking are the world's third and fourth most-profitable criminal activities, behind drug trafficking and the sale of counterfeit goods. The Financial Action Task Force estimates that environmental crime alone—including forestry-related crime, illegal mining, and waste trafficking—generates $110 billion to $281 billion in illicit funds a year.[1] Transparency International estimates the global cost of corruption, including bribery, to be at least $2.6 trillion per year, or 5% of the global gross domestic product.[2]

Although FCC and ESG monitoring traditionally focus on different areas, it is becoming increasingly clear that they can complement each other to support the fight against financial crime. ESG monitoring broadens the scope of scrutiny beyond the standard KYC practices by evaluating a wider range of information, such as negative reports on a company's activities, ESG disclosures, and third-party ESG ratings. This approach can enhance due diligence, particularly for companies in sensitive sectors like logging, land clearing, forestry, mining, and waste trafficking, which are already subjected to more rigorous assessments by financial institutions.

Furthermore, financial institutions are also implementing proactive measures in the KYC space to address potential ESG-related risks. These include addressing the misuse of shell and front companies that camouflage unlawful activities, incorporating new keywords and criteria into adverse media searches, and re-rating customer risk profiles to account for illicit ESG activities. By integrating these practices, financial institutions can better detect and prevent financial crimes linked to environmental and social misconduct, enhancing both compliance efforts and overall sustainability objectives.

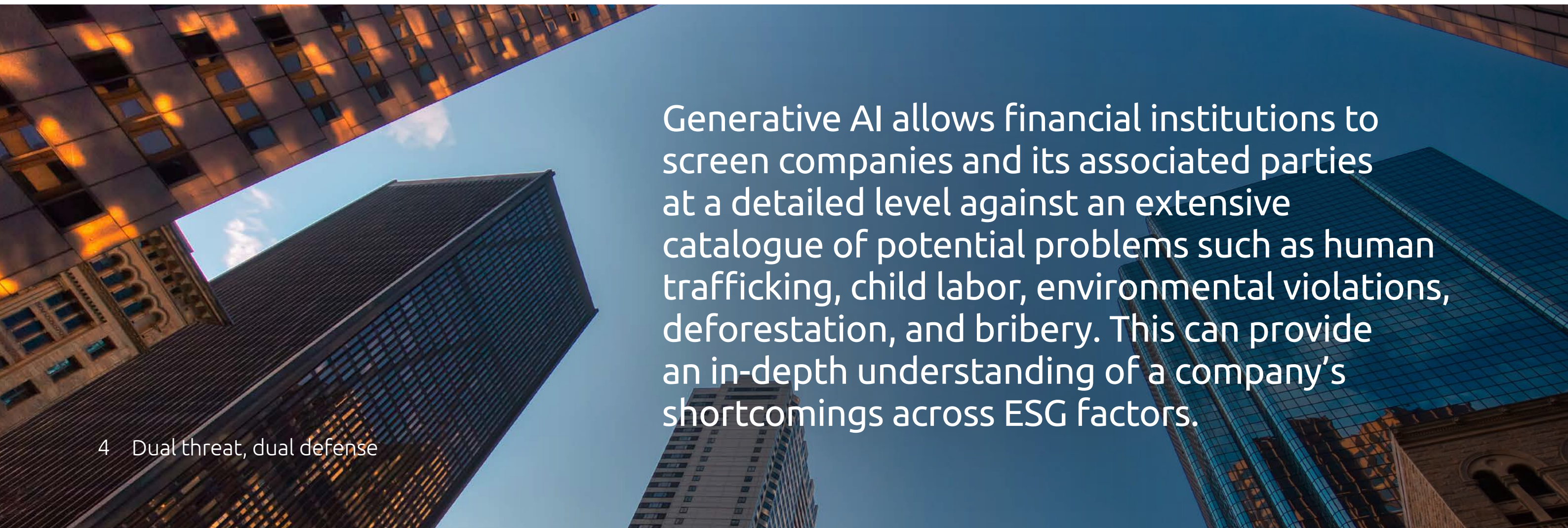
By utilizing technologies such as generative AI, screening can extend beyond a specific company to include the behavior and actions of its partners, suppliers, customers, and other associated parties. With the help of natural language processing, it can assess unstructured data from sources such as global and regional news, litigations, social media, proxy voting, shareholder proposals, public records and documents, and investigative articles in the media.

> *Our bank has rejected the onboarding of clients based on the behavior of their board of directors that does not align with ESG considerations*
>
> ***Global Lead, KYC Onboarding, international bank***

FCC operations, on the other hand, focus largely on financial transactions. Institutions will scrutinize not only a company's transactions with immediate customers, suppliers, and lenders, but also the transactions that those parties have with their partners through several tiers of business relationships. This enables institutions to monitor an extensive network of transactions to identify suspicious patterns in the movement of money. To find flows of illicit funds, FCC will at times include some negative screening of news reports similar to ESG, but typically only for the primary entity.

Today's technology enables institutions to expand the use of ESG data and incorporate a broader scope of information into their efforts, creating a more comprehensive picture of potential criminal activity.[3] ESG data provides insight into the activities of companies and their associates that generate illicit funds, while FCC information reveals how those funds are moved and concealed.

Such insights not only strengthen an institution's ability to uncover financial crimes, they also make it possible to do so earlier. Troubling ESG behavior is typically the predicate crime to money laundering and other financial crimes. Thus, the integration of ESG principles into FCC enables institutions to anticipate crimes. In short, ESG factors can serve as valuable early indicators of financial wrongdoing among an institution's customers, making it possible to predict risks and act quickly to strengthen their defenses against illicit activity.



ESG and FCC
Connecting the dots

To contend with the intersection of ESG-related problems and financial crime, financial institutions need to be on the lookout for criminals who are often sophisticated and innovative. Here are several recent real-world examples that made headlines in the media.

In Madagascar, criminals were illegally logging rosewood, a protected species. In 76 cases referred to the courts, authorities cited illegal financial flows of $160 million from this activity, running from 2009 to 2020. Criminals often laundered those funds through the country's vanilla industry, a highly cash-intensive business. They would do so by buying large amounts of domestic vanilla to manipulate prices to hide the integration of illicit funds into the vanilla business. [4]

In 2023, Italian and German authorities announced that they had arrested 14 people and seized €90 million in assets in a case involving an illicit waste-trafficking scheme. Officials said that the criminal group illegally acquired scrap iron through a network of companies in several countries, and then sold it on the legal market as steel imported from Germany—without proper recycling or cleaning. Cash was transferred through several fictitious companies in other countries, with some profits eventually being laundered through legitimate business activities, including the purchase of a football team in Italy. [5]

In 2021, the U.S. Department of Justice announced the indictment of 24 people for human smuggling and labor trafficking that illegally imported Mexican and Central American workers to work on farms in southern Georgia. Prosecutors said that the group forced the victims to work for little or no pay, "housing them in crowded, unsanitary, and degrading living conditions, and by threatening them with deportation and violence." Officials estimated that the group had earned more than $200 million from the scheme, with the funds being laundered "through cash purchases of land, homes, vehicles, and businesses; through cash purchases of cashier's checks; and by funneling millions of dollars through a casino." [6]

Unleashing the full potential of ESG and FCC data

While a growing number of financial institutions and regulators see value in combining the perspectives of both ESG and FCC, many are still in the early stages of doing so—and often, they are looking for ways to proceed. For most financial institutions, integrating ESG factors into FCC monitoring will be relatively inexpensive because it involves the modification of two existing capabilities, rather than implementing an entirely new platform. But there are several key guidelines that are important to the effective expansion of FCC:

Align ESG and FCC: Expand FCC negative screening by integrating ESG factors into frameworks used for customer due diligence and extended due diligence, which is used for potentially high-risk customers. ESG attributes can be tailored to create a unified search taxonomy that focuses on uncovering financial crime and supporting FCC, rather than broader ESG issues. For example, polluting a river is wrong, but it is unlikely to lead to revenue that needs to be hidden and laundered.

Broaden risk scores by fully converging ESG and FCC: Incorporate ESG insights, based on the screening of multiple levels of company relationships, into periodic ongoing customer reviews and case investigations. In addition, institutions should develop ESG scorecards for companies and their networks of related companies for use in creating customer risk scores.

Leverage GenAI to conduct ongoing monitoring with a reduction of false alerts: Use of generative AI for expanded monitoring allows more factors at more levels of relationships. Thus, it will naturally increase the number of alerts flagging potential criminal activities, which can be overwhelming. Generative AI can help institutions eliminate noise in their monitoring efforts and focus on the right problems with minimal effort.

Expand the use of machine learning to enhance FCC monitoring: This can help financial institutions stay ahead by continuously refining detection models, identifying new patterns, extending screening across all relationships rather than just the primary entity, and adapting to emerging threats in real-time.

> *Despite the growing importance of ESG considerations, policy clarity and integration of ESG factors into KYC processes are still in the early stages across many institutions. There's a need for clearer guidance and standardized approaches.*
>
> **Compliance Officer major European bank**

Enhancing current FCC frameworks and procedures to include ESG concerns can make FCC more effective while eliminating redundant processes and reducing the overall supervisory burden. That's a key point, given the high costs of compliance, especially for institutions operating across different jurisdictions. But the real benefits go far beyond greater efficiency.

By integrating ESG insights into their FCC efforts, financial institutions can develop a comprehensive view of their risk exposure, enhance their ability to detect criminal activities, and strengthen their overall compliance measures. An important link between ESG and FCC arises in the area of sanctions, where sanctions laws and regulations help institutions avoid dealings with rogue regimes and terrorist groups while promoting human rights by targeting issues like forced labor and human trafficking. To address ESG-related risks, sanctions screening lists, keywords, and logic are often updated to more easily identify bad actors.

This approach highlights the growing importance of ESG in compliance strategies, where the penalties for non-compliance can be severe. For instance, in 2020, an Australian bank agreed to a $920 million settlement with regulators after failing to implement adequate transaction monitoring to identify transfers related to child exploitation. By aligning ESG considerations with FCC frameworks, financial institutions not only bolster their defenses against financial crime but also support broader societal goals, such as human rights and environmental protection.[7]

Improved compliance and better risk management are clear and immediate payoffs of ESG and FCC convergence, but bringing both domains together can also drive a variety of broader benefits. It can, for example, help strengthen an institution's brand and reputation, especially among customers who place importance on ethical behavior and sustainability. It can also improve investors' confidence in an institution's ability to manage compliance and reduce risk, as well as increase an institution's appeal to investors looking for companies that embrace ESG goals.

Identifying the root cause with a structured framework

To keep pace with evolving financial crimes, regulators such as the European Parliament regularly issue anti-money laundering (AML) directives that member states must implement into their domestic legislation. The latest directive identifies 22 predicate offenses or activities that have the potential to generate illicit gains and lead to money laundering. Similarly, FinCEN recently outlined key AML national priorities, including corruption, cybercrime, terrorist financing, fraud, transnational criminal activities, drug trafficking, human trafficking, and proliferation financing. This alignment shows that specific ESG concerns, such as human trafficking and corruption, are increasingly recognized as critical priorities within AML frameworks, underscoring the growing regulatory focus on integrating ESG considerations to more effectively combat financial crime.

Overlap between ESG factors and FCC screening

Amount of overlap

ESG pillar

Predicate offenses

Environment

- Environmental crimes, such as pollution, illegal waste disposal, wildlife trafficking
- Illicit trafficking of certain cultural goods, such as endangered species

Social

- Terrorism financing
- Drug trafficking
- Arms trafficking
- Organized crime (including its involvement in social issues such as human trafficking)
- Kidnapping and extortion
- Human trafficking and smuggling
- Sexual exploitation
- Counterfeiting of currency and/or products, which can have social impacts if poor-quality products harm consumers

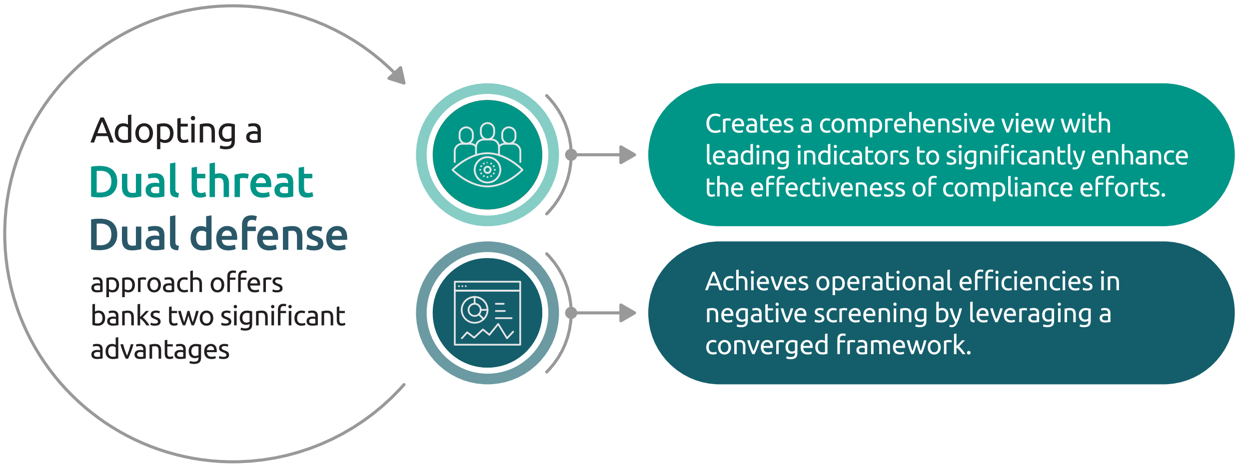
Governance

- Tax crimes
- Fraud
- Corruption
- Bribery
- Cybercrime (depending on the target, cybercrime can disrupt social services or cause economic damage)
- Theft and robbery
- Illicit trafficking of arms
- Counterfeiting of currency, which can undermine trust in financial systems
- Mismanagement of cultural goods (poor governance can lead to a lack of protection for cultural artifacts)

Due to limited overlap, there is a substantial opportunity within the Environment pillar to extend traditional FCC screening practices.

Dual threat, dual defense

The connection between ESG-related behavior and financial crime is becoming increasingly evident, highlighting the critical role that ESG can play in identifying and mitigating such risks. Leveraging the technology, data, expertise, and systems traditionally used in AML processes to assess ESG risks creates a more comprehensive and robust risk management strategy. Conversely, insights and disclosures from ESG assessments can enhance FCC compliance by adding valuable context and identifying potential risk factors that might otherwise be overlooked. This reciprocal use of information not only strengthens the institution's capacity to combat financial crime but also promotes more responsible and ethical business practices across the board.



As financial institutions face increasing demands for transparency and accountability from stakeholders, the integration of ESG into FCC frameworks becomes not a matter of if, but when. Institutions that embrace this convergence will not only enhance their risk management capabilities but also strengthen their reputation, appeal to socially conscious investors, and build stronger, more ethical relationships with their clients. As the financial landscape continues to evolve, the convergence of ESG and FCC will be essential in shaping the future of banking.

Endnotes

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2. https://blogs.worldbank.org/en/governance/what-are-costs-corruption
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Contacts

Arindam Choudhury
EVP, Banking & Capital Markets Head
Financial Services Insights & Data
arindam.choudhury@capgemini.com

Satish Weber
EVP, Head of Sustainability
Financial Services
satish.weber@capgemini.com

Tej Vakta
Global Head of Sustainability Solutions
Financial Services Insights & Data
tej.vakta@capgemini.com

Acknowledgments

The authors wish to thank the following professionals for their contributions:
Manish Chopra *(Executive Vice President, Financial Services)*
Jeffrey Ingber *(Senior Advisory Consultant, Regulatory and Compliance)*
Preeti Malik *(Senior Director, Financial Services Insights & Data)*

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