

# Anti-Money Laundering Risk in Trade Finance

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# What is Trade Finance ?

**Trade Finance** (TF) is the financing of international trade flows. Banks act as intermediaries to assist buyers and sellers with the trade cycle funding gap and to mitigate risk

Trade Finance is critical for the global economy, with the World Trade Organization estimating that 80-90% of global trade relies on this type of financing. Banks and Financial Institutions offer multiple solutions in order to facilitate the purchase and shipment of goods, including:

Finance Instrument	Description
<b>Letters of Credit (LCs)</b>	<ul style="list-style-type: none"><li>• LCs allow an Issuing Bank to substitute its own creditworthiness for that of its client, providing the exporter with better assurance of payment</li></ul>
<b>Guarantees</b>	<ul style="list-style-type: none"><li>• Much like LCs, a guarantee represents the Issuing Bank's commitment to making a payment on behalf of a client, upon the occurrence of a particular event</li></ul>
<b>Banker's Acceptance</b>	<ul style="list-style-type: none"><li>• A promised future payment, or time draft, which is accepted and guaranteed by a bank and drawn on a deposit at the bank</li></ul>
<b>Open Account Financing</b>	<ul style="list-style-type: none"><li>• Banks leverage relationships with a buyer or seller in order to finance the seller through Purchase Order Financing or Accounts Receivable Financing</li></ul>
<b>Export Credit Programs</b>	<ul style="list-style-type: none"><li>• Solutions offered to governmental or supranational clients, where banks work closely with Export Credit Agencies to alleviate risk involved in lending programs</li></ul>
<b>Specialized Trade Financing</b>	<ul style="list-style-type: none"><li>• Leveraging specialized knowledge and risk frameworks, solutions such as factoring and commodity trade financing to help enhance cash conversion cycles and hedge risks</li></ul>
<b>Financial Supply Chain</b>	<ul style="list-style-type: none"><li>• Financing options to facilitate better terms for payment and collection times, optimizing working capital for both buyer and seller</li></ul>

# Main Risks Associated with Trade Finance

Although Trade Finance was traditionally considered a lower-risk activity, due to its short-term, self-liquidating, and collateralized characteristics, growing complexities and volume of trade flows create opportunities for criminal activities. And with that, grows the need for increasingly comprehensive risk control measures. The Office of the Comptroller of the Currency (OCC) has defined eight categories of risks: credit, interest rate, liquidity, price, strategic, operational, compliance and reputational.

## AML Related Risks

1

### Operational Risk

- Heavy reliance on manual processing and paper documentation
- Susceptibility to missing, incomplete, or fraudulent documentation
- Unclear terms or nonstandard language may nullify traditional protections to a bank

2

### Compliance Risk

- Including risk of failure to comply with BSA, AML, OFAC Sanctions
- Risk of failure to comply with similar requirements in a foreign counterpart's country

3

### Reputational Risk

- A Bank's reputation is important for Trade Finance activities, and lack of due diligence or compliance with BSL and AML regulations may ultimately reduce the number of business opportunities

# Regulations Impacting Trade Finance

Banks that provide trade finance services are under significant regulatory pressure to develop consistent standards across the complete suite of trade finance products to mitigate compliance risks.

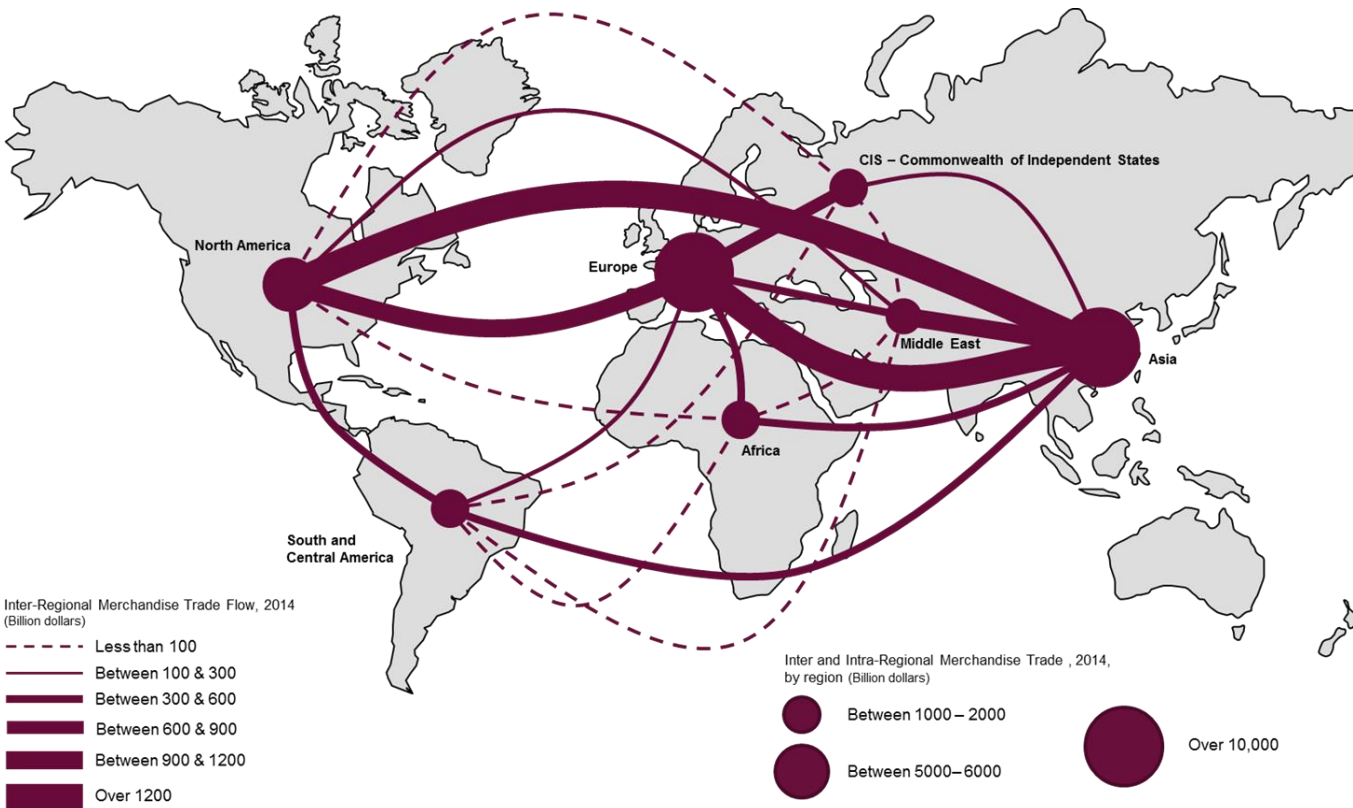
Legislation	Description	Scope	Objective
<b>USA PATRIOT Act, Title III</b>	Title III of the USA PATRIOT ACT, the “International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001” instituted stricter requirements for AML reporting, enhanced due diligence on new foreign accounts, and prohibited the ownership of correspondent accounts in Foreign Shell Banks.	Financial Institutions, including nonbank financial institutions and U.S. subsidiaries of foreign financial institutions	Intercept and obstruct Terrorism
<b>Bank Secrecy Act (“BSA”)</b>	Trade finance activities of banks are subject to AML laws and regulations of the BSA and must be part of a bank’s BSA compliance program. The Bank Secrecy Act must include a customer identification program with risk-based procedures that enable the bank to form a reasonable belief that it knows the true identity of its customers.	Financial institutions in the United States	Detect and prevent money laundering
<b>OFAC Compliance</b>	OFAC administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign countries, terrorists, international narcotic traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction.	Banks in the United States, including foreign branches and foreign subsidiaries of U.S. banks	Support U.S. national security
<b>Export Administration Act of 1979</b>	The anti-boycott provisions of the Export Administration Act of 1979 prohibited U.S. persons or entities from engaging in transactions related to boycotts imposed by foreign countries that are not sanctioned by the United States.	Commercial letter of credit transactions when the beneficiary is a U.S. person	Prevent U.S. firms from being used to implement foreign policies which run counter to U.S. policy

# Trade Based Money Laundering – A Growing Concern

## Trade-Based Money Laundering (TBML):

The process by which criminals use a legitimate trade to disguise criminal proceeds from their unscrupulous sources. TBML is a global and fast growing concern for banks.

### Inter and Intra-Regional Merchandise Trade, 2014



**2 to 5%**

Global Money Laundering transactions are estimated to account for 2-5% of Global GDP

**< 1%**

of global illicit financial flows are currently seized by authorities

**> 80%**

of illicit financial flows from developing countries are accomplished through TBML

Note: An estimated **\$2.3 trillion** was moved out of the US from 2003 to 2014 as a result of pricing anomalies (over-invoiced imports and under-invoiced exports).

# Trade Based Money Laundering – Why is it Important ?

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Trade Based Money Laundering (TBML) was recognized by the Financial Action Task Force as one of the three main methods by which criminal organizations and terrorist financiers move money for the purpose of disguising its origin and integrating it back into the formal economy.

## Why is TBML so prevalent?

- The key is with its **complexity**, as not only does it involve sectorial boundaries but also national borders (**International Trade**).
- The elevated use of effective AML Controls by Financial Institutions are pushing financial criminals to use more complex schemes and techniques to smuggle funds and manipulate the Financial System.

## Main challenges



International Trade is extensive and growing



Limited exchange of information between banks and countries



Reliance on large volume of complex documentation



Variety and Complexity of Trade Products and Trade Financing Arrangements

# Trade Based Money Laundering – Common Techniques

Trade Misinvoicing is not only the most significant form of TBML, but also the largest component of illicit financial outflows as measured by Global Financial Integrity. Misinvoicing is used for the 4 following reasons:

- Money Laundering
- Evading Taxes and Customs Duties
- Claiming Tax Incentives
- Dodging Capital Controls

*Below are some of the main techniques used in trade misinvoicing:*

## **Under-invoicing** – Enables the exporter to transfer value to the importer

- ▶ Trade goods are invoiced at a price below the fair market price - the importer is then transferred value from the exporter as the payment for the trade goods will be lower than the fair market value of goods the importer receives.

## **Over-invoicing** – Enables the importer to transfer value to the exporter

- ▶ Trade goods are invoiced at a price above the fair market price - the exporter is then transferred value from the importer as the payments for the trade goods will be higher than the fair market value of goods the exporter has sent.

## **Multiple Invoicing** – A money launderer or terrorist can justify multiple payments for the same shipment

- ▶ More than one invoice for the same international trade transaction, which enables a money launderer or terrorist financier to justify multiple payments for the same shipment.

## **Over and Under-Shipment** – Most extreme case is “Phantom Shipments”

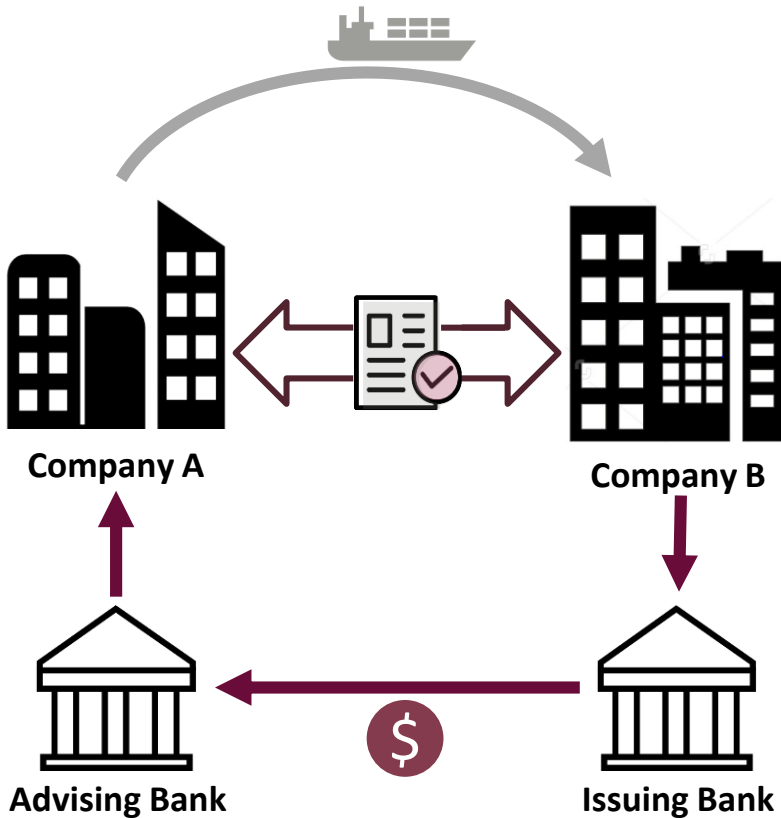
- ▶ The quantity of goods shipped relative to the payments sent/received is overstated or understated.

## **False Description of Trade Goods** – misrepresenting the quality or type of the goods

- ▶ The quality or type of the trade goods is misrepresented.

# A Bank's Role

Banks facilitate global trade by offering various financial products (e.g. Letters of credit, guarantees, etc.) and thus play a vital role in mitigating the risk associated with Trade Based Money Laundering. In order to effectively minimize this risk, banks must effectively perform the following:



**KYC & Customer Relationship:** Maintaining an effective “Know Your Customer” (KYC) Program is critical to assess and monitor customer risk. KYC refers to the steps taken by a Financial Institution to:

1. Establish the identity of the customer;
2. Understand the nature of the customer’s activities; and
3. Assess the customer money laundering risks to establish the necessary level of monitoring



**Trade-related Due Diligence:** Due diligence should include gathering sufficient information on Applicants and Beneficiaries as well as information on the goods traded and the methods of transportation (i.e. vessels).



**Transaction Monitoring:** Transaction Monitoring Program should monitor and alert transactions for potential violations of Anti-Money Laundering Laws and Sanctions Programs.

“Banks deal with documents and not with goods, services or performance to which the documents may relate” – ICC (UCP 600)



# Anti-TBML Best Practices

Financial institutions and other trade-related enterprises can pursue several in-house avenues to mitigate TBML risks to their business. Best practices related to mitigating TBML risks include the following:

## Main Components of Anti-TBML

KYC & Customer Relationship	Trade-related Due Diligence	Transaction Monitoring
<ul style="list-style-type: none"> <li>• Proper and documented onboarding process</li> <li>• Regular updates of customer information</li> <li>• Strong relationship management</li> </ul>	<ul style="list-style-type: none"> <li>• Automated screening (countries, vessel, sanctions)</li> <li>• Identification of “dual-use goods”</li> </ul>	<ul style="list-style-type: none"> <li>• Identification of unusual or suspicious trade-based activities</li> <li>• Identification of discrepancies between expected vs. actual activity</li> </ul>

Red Flags Identification

## Strategic Levers

### A Strong Governance

- Clear Roles & Responsibilities
- Dedicated Policies & Procedures
- Proper Management and Oversight

### Awareness & Training

- Increase of staff and analysts’ skills

### System & Data

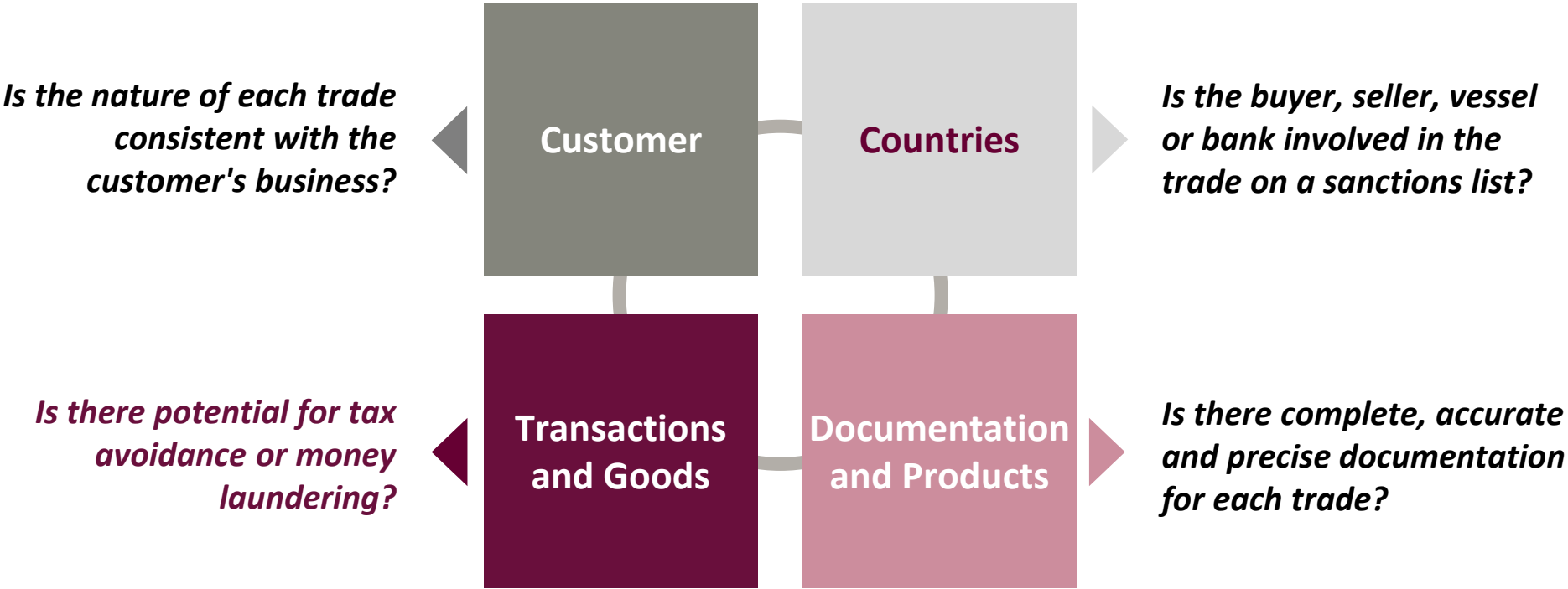
- Automated document scanning, text analytics, web analytics, unit prices and weight analysis, Network analysis...

### Risk Assessment / Audit

- Adopt risk-based approach for TF activities
- Assess robustness of controls

# Anti-TBML Best Practices – Red Flag Identification (1/3)

Although Trade Based Money Laundering is extremely difficult to monitor, track and identify, there are common situational or behavioral indicators, or “Red Flags”, that Financial Institutions should be aware of:



Red flags may be present in every step of the Trade Finance process, and should be promptly examined. Although it is not necessarily an indicator of criminal activity, the presence of a Red Flag requires thorough investigation, in order to properly determine if unlawful acts were committed.

# Anti-TBML Best Practices – Red Flag Identification (2/3)

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1

## Customer

- Excessive insistence of the customer to complete the transaction quickly.
- Transactions which involve front or shell companies.
- Transactions which are between parties controlled by the same business entity.
- Transactions which are inconsistent with the customer's business and transaction history.
- Transacting parties who share the same address or lack a valid address.
- Clear disregard to apparent discrepancies by the customer.

2

## Countries

- Inability of the customer to produce invoices, bills of lading, or other appropriate documentation, to support a requested bank transaction.
- A shipment to or from a jurisdiction designated as high risk for money laundering activities (i.e. OFAC sanctioned countries).
- Trans-shipment of the trade goods through one or more jurisdictions for no apparent economic reason (or any other justifiable reason).
- Receipt of cash or other payments from third party entities that have no apparent connection to the transaction.

# Anti-TBML Best Practices – Red Flag Identification (3/3)

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3

## Transactions and Goods

- A significant discrepancy between the product/commodity's value as reported on the invoice and its fair market value.
- Trade goods that are designated as dual-use technologies or products.
- Trade goods that are designated as high-risk for money laundering activities.
- An important discrepancy between the description of the trade goods on the invoice and the bill of lading/actual goods shipped.
- Unexpected changes to payment orders.
- Unusual use of intermediaries during the transaction process.

4

## Documentation and Products

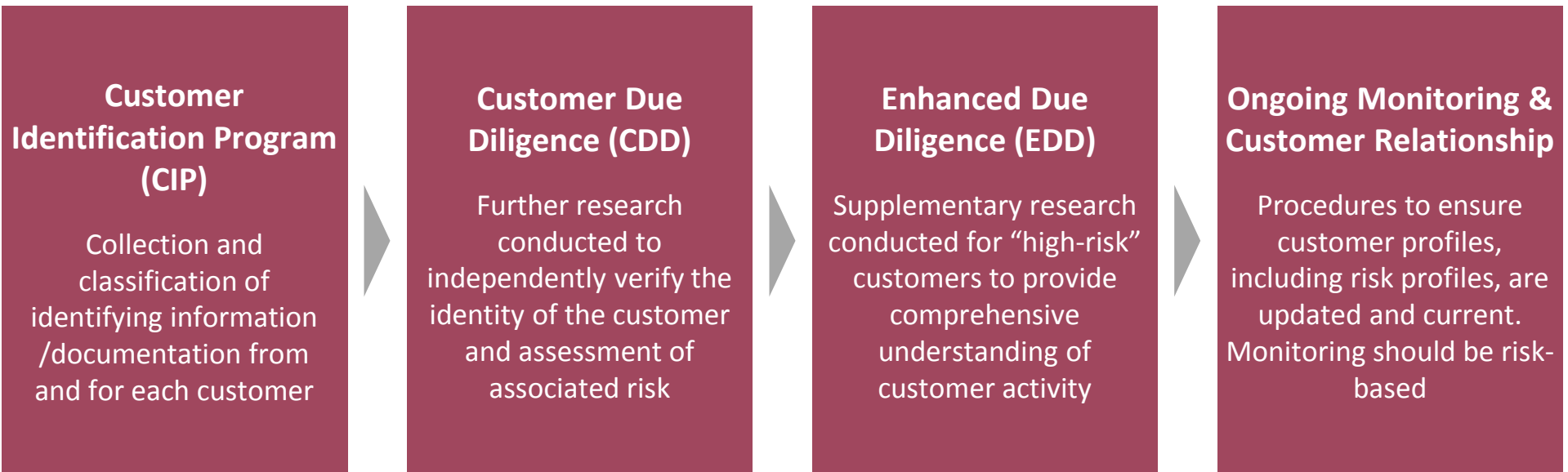
- “Unnecessarily complex” and confusing transaction structures. These structures potentially aim to obscure a transaction's true purpose and nature.
- A payment method that does not match the risk characteristics of the transaction.
- A transaction that involves the use of repeatedly amended or frequently extended terms (e.g. letters of credit).
- Requests by exporters to take back and replace trade and shipping documents, notably if the new documents provided have been altered or issued by a different entity.
- Abnormal markings on monetary instruments.
- Modifications to third party documents, such as Customs forms.

# KYC & Customer Relationship

“Know Your Customer” (KYC) Policies and Procedures are imperative to identifying and evaluating the risk associated with each customer. A successful KYC program should allow Financial institutions to:

1. Establish a comprehensive and complete profile or identity for each customer;
2. Understand the nature of the customer’s activities, with a goal to assure themselves that the customer’s source of funds are legal and legitimate; and
3. Assess money laundering risks that are associated with that customer and follow a risk-based approach to determine the appropriate degrees of due diligence and monitoring to be performed.

## KYC



# Trade-related Due Diligence

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Through sufficient documentation, Banks should aim to be able to answer the following questions for each of their customers and for each transaction that their customers perform.

**The Customer**

*Is the nature of each trade consistent with the customer's business?*

**Documentation**

*Is there complete, accurate and precise documentation for each trade?*

**Sanctions**

*Is the buyer, seller, vessel or bank involved in the trade on a sanctions list?*

**Goods**

*Is the type and amount of goods traded in line with the customer profile?*

**Dual-Use Items\***

*Are there goods identified which are on controlled lists?*

*\* **Dual use items** consist of goods, software and technology that can be used for both civilian and military applications and/or can contribute to the proliferation of Weapons of Mass Destruction. These items are subject to controls to prevent the risks that they may pose for international security.*

# Transaction Monitoring (1/2)

To effectively identify and mitigate Trade Based Money Laundering Risks, Financial Institutions need to maintain an effective Transaction Monitoring Program that monitors and alerts transactions for potential violations of Anti-Money Laundering Laws and Sanction Programs.







A Transaction Monitoring Program should be systematic and efficient, with an aim to include the following, organized in three stages:

Capture and Collect	Alert and Highlight	Review and Update
<ul style="list-style-type: none"><li>• Capture all relevant Transaction Details for both the originator and beneficiary parties</li><li>• Collect trade data from various public databases to be used as a benchmark for scenarios</li><li>• Capture bill of lading information and container numbers (including from online websites)</li><li>• Create electronic versions of forms to easily identify customer profile discrepancies</li></ul>	<ul style="list-style-type: none"><li>• Automatically alert in case of clear violation of Anti-Money Laundering Laws or Sanctions Programs</li><li>• Highlight Politically Exposed Persons (PEPs) associated with the relevant parties</li><li>• Highlight negative news regarding parties such as exporters, shipping companies, and importers</li><li>• Automatically alert in case of unusual activity or significant discrepancies between expected and actual activity</li></ul>	<ul style="list-style-type: none"><li>• Include controls to mitigate manual entry errors</li><li>• Perform Enhanced Due Diligence on Suspicious Activity</li><li>• Update Customer Profile for any changes in actual activity or identity (i.e. risk profile)</li><li>• Update transaction monitoring program due to changes in regulatory environment or the Bank's inherent risk</li></ul>

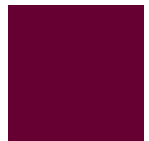
# Transaction Monitoring (2/2)

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Maintaining an effective transaction monitoring program can be difficult and onerous. However, if Financial Institutions focus on the 6 points below, they will be on the right track to ensure quality within their systems:

-  **System Integration:** Good integration between customer on-boarding system, customer activity systems and transaction monitoring systems can simplify the processes behind AML Monitoring, Name & Transaction Screening.
-  **Using Appropriate Rules:** The parameters should reflect the risk associated with the customer type/business activity/business unit as well as the risk appetite of the specific Financial Institution.
-  **Accuracy and Integrity of Data Inputs:** Inputs can be put into the system incorrectly, thus the Bank should conduct periodic reviews of the Data inputs in the system.
-  **Dual-Review Procedures:** Financial Institutions should rely on two analysts to evaluate whether or not to escalate respective alerts.
-  **Backlogs:** Financial Institutions should be prepared to deal with backlogs so as to avoid having too many alerts which need to be investigated.
-  **Policies and Procedures:** Financial Institutions should maintain documentation as well as policies and procedures that demonstrate that the Bank has an efficient and precise approach to tackling AML.



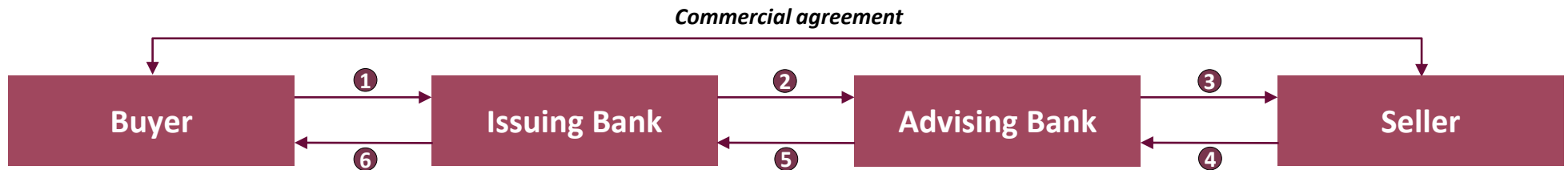


# Appendix

# Appendix: Trade Finance – Letter of Credit (1/2)

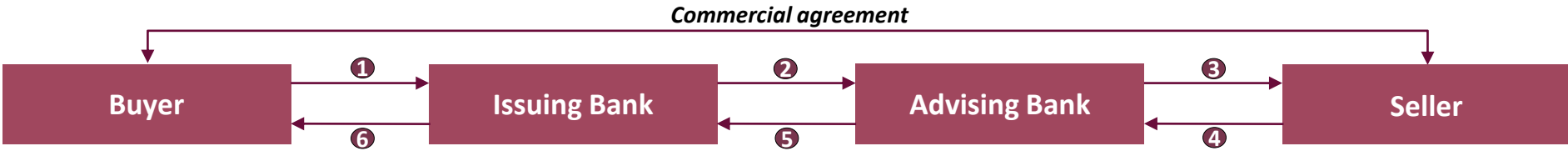
## Principle:

The Buyer and the Seller enter into a commercial agreement. As a guarantee, before proceeding with the delivery, the Seller requests a Letter of Credit(LC). To do so, the Buyer, through their Issuing Bank, issues a Letter of Credit in favor of the Seller. The Advising Bank is then designated to advise and send the Letter of Credit to the Seller locally.



- ① Letter of Credit Application: The Buyer requests its bank to issue a Letter of Credit in accordance with the terms of the agreement with the Seller. The Issuing Bank should ensure that the LC documentation is accurate.
- ② Issuance of the LC: The LC is issued to the Advising Bank. The first responsibility of the Advising Bank is to ensure the authenticity of the credit. The Advising Bank should then make sure that the LC accurately reflects the terms and conditions of the credit received.
- ③ Advise the LC to the seller: The Seller verifies that the LC is complete and accurate and ensures that the conditions specified are met as soon as the LC is received. Once agreed, the Seller starts producing and/or shipping the goods.
- ④ Documents collected and sent: Once goods are loaded for shipment, all the documents requested by the LC (Bill of Lading, trade invoice, etc.) are sent by the Seller to the Advising Bank.
- ⑤ Document transmission: The Advising Bank transmits the documents to the Issuing Bank. The Issuing Bank will then be responsible to check the documents according to the terms and conditions of the credit. Once the documents are validated, the issuing bank proceeds with the payment claim and sends the documents to the Buyer.
- ⑥ Document transmission: The Buyer receives the documents.

# Appendix: Trade Finance – Letter of Credit (2/2)



	Issuing Bank	Advising Bank
RISKS	<p>By issuing a LC, the Issuing Bank could identify risks and red flags:</p> <ol style="list-style-type: none"> <li>1. Nature of the goods ordered (not aligned with the expected activity of the buyer, origins, quantities, etc.)</li> <li>2. Country and name of supplier on sanctions/terrorist listing</li> <li>3. Risks associated with the LC structure               <ol style="list-style-type: none"> <li>i. Payment instructions amended several times</li> <li>ii. Complexity of the financial products used</li> </ol> </li> <li>4. Country and name of Advising Bank and reputation</li> <li>5. False payment information</li> </ol>	<p>The Advising Bank in this scenario is not the initiator of the LC. However, the Advising Bank should identify potential risks related to the Seller. The level of risk associated with the Seller will be higher if the relationship is new:</p> <ol style="list-style-type: none"> <li>6. Risks related to LC issued:               <ol style="list-style-type: none"> <li>vi. Location, Original Buyer and Issuing Bank</li> <li>vii. Goods described in the LC (consistency with both activities of the two parties)</li> </ol> </li> <li>7. Documents transmitted by Seller could be inconsistent with the LC</li> <li>8. False payment information when processing the payment to the Seller</li> </ol>
BEST PRACTICES	<ul style="list-style-type: none"> <li>• Following KYC procedures, perform due-diligence on the Issuing Bank (i.e. third-parties (supplier, agents), nature of the goods traded, etc.)</li> <li>• Review the initial LC and the needs of the transaction including verification screening, nature of the goods traded</li> <li>• Review Information about the supplier (reputation and origin), the documents presented through the advising bank for the LC</li> <li>• Review of the payment information</li> <li>• Perform due diligence on the Advising Bank in order to identify potentials risks.</li> <li>• Monitor accounts and activities of the Buyer as an existing customer of the bank</li> </ul>	<p>Depending on whether the Seller is already a client or not, the Advising Bank should perform a complete due diligence on the Seller. If it is an existing relationship, the due diligence should already have been performed;</p> <ul style="list-style-type: none"> <li>• Due diligence should include name screening following a risk-based approach</li> <li>• Further steps include exercising due diligence on the issuing bank</li> <li>• When receiving the documents from the Seller, ensure consistency with initial LC</li> </ul>

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