

## Trade Finance Activities — Overview

**Objective.** *Assess the adequacy of the bank's systems to manage the risks associated with trade finance activities, and management's ability to implement effective due diligence, monitoring, and reporting systems.*

Trade finance typically involves short-term financing to facilitate the import and export of goods. These operations can involve payment if documentary requirements are met (e.g., letter of credit), or may instead involve payment if the original obligor defaults on the commercial terms of the transactions (e.g., guarantees or standby letters of credit). In both cases, a bank's involvement in trade finance minimizes payment risk to importers and exporters. The nature of trade finance activities, however, requires the active involvement of multiple parties on both sides of the transaction. In addition to the basic exporter or importer relationship at the center of any particular trade activity, relationships may exist between the exporter and its suppliers and between the importer and its customers.

Both the exporter and importer may also have other banking relationships. Furthermore, many other intermediary financial and nonfinancial institutions may provide conduits and services to expedite the underlying documents and payment flows associated with trade transactions. Banks can participate in trade financing by, among other things, providing pre-export financing, helping in the collection process, confirming or issuing letters of credit, discounting drafts and acceptances, or offering fee-based services such as providing credit and country information on buyers. Although most trade financing is short-term and self-liquidating in nature, medium-term loans (one to five years) or long-term loans (more than five years) may be used to finance the import and export of capital goods such as machinery and equipment.

In transactions that are covered by letters of credit, participants can take the following roles:

- **Applicant.** The buyer or party who requests the issuance of a letter of credit.
- **Issuing Bank.** The bank that issues the letter of credit on behalf of the Applicant and advises it to the Beneficiary either directly or through an Advising Bank. The Applicant is the Issuing Bank's customer.
- **Confirming Bank.** Typically in the home country of the Beneficiary, at the request of the Issuing Bank, the bank that adds its commitment to honor draws made by the Beneficiary, provided the terms and conditions of the letter of credit are met.
- **Advising Bank.** The bank that advises the credit at the request of the Issuing Bank. The Issuing Bank sends the original credit to the Advising Bank for forwarding to the Beneficiary. The Advising Bank authenticates the credit and advises it to the Beneficiary. There may be more than one Advising Bank in a letter of credit transaction. The Advising Bank may also be a Confirming Bank.
- **Beneficiary.** The seller or party to whom the letter of credit is addressed.
- **Negotiation.** The purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) or documents under a complying presentation, by advancing or

agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank.

- **Nominated Bank.** The bank with which the credit is available or any bank in the case of a credit available with any bank.
- **Accepting Bank.** The bank that accepts a draft, providing a draft is called for by the credit. Drafts are drawn on the Accepting Bank that dates and signs the instrument.
- **Discounting Bank.** The bank that discounts a draft for the Beneficiary after it has been accepted by an Accepting Bank. The Discounting Bank is often the Accepting Bank.
- **Reimbursing Bank.** The bank authorized by the Issuing Bank to reimburse the Paying Bank submitting claims under the letter of credit.
- **Paying Bank.** The bank that makes payment to the Beneficiary of the letter of credit.

As an example, in a letter of credit arrangement, a bank can serve as the Issuing Bank, allowing its customer (the buyer) to purchase goods locally or internationally, or the bank can act as an Advising Bank, enabling its customer (the exporter) to sell its goods locally or internationally. The relationship between any two banks may vary and could include any of the roles listed above.

## Risk Factors

The international trade system is subject to a wide range of risks and vulnerabilities that provide criminal organizations with the opportunity to launder the proceeds of crime and move funds to terrorist organizations with a relatively low risk of detection. The involvement of multiple parties on both sides of any international trade transaction can make the process of due diligence more difficult. Also, because trade finance can be more document-based than other banking activities, it can be susceptible to documentary fraud, which can be linked to money laundering, terrorist financing, or the circumvention of OFAC sanctions or other restrictions (such as export prohibitions, licensing requirements, or controls).

While banks should be alert to transactions involving higher-risk goods (e.g., trade in weapons or nuclear equipment), they need to be aware that goods may be over- or undervalued in an effort to evade anti-money laundering or customs regulations, or to move funds or value across national borders. For example, an importer may pay a large sum of money from the proceeds of an illegal activity for goods that are essentially worthless and are subsequently discarded. Alternatively, trade documents, such as invoices, may be fraudulently altered to hide the scheme. Variations on this theme include inaccurate or double invoicing, partial shipment of goods (short shipping), and the use of fictitious goods. Illegal proceeds transferred in such transactions thereby appear sanitized and enter the realm of legitimate commerce. Moreover, many suspect trade finance transactions also involve collusion between buyers and sellers.

The Applicant's true identity or ownership may be disguised by the use of certain corporate forms, such as shell companies or offshore front companies. The use of these types of entities results in a lack of transparency, effectively hiding the identity of the purchasing party, and thus increasing the risk of money laundering and terrorist financing.

## Risk Mitigation

Sound CDD procedures are needed to gain a thorough understanding of the customer's underlying business and locations served. The banks in the letter of credit process need to undertake varying degrees of due diligence depending upon their role in the transaction. For example, Issuing Banks should conduct sufficient due diligence on a prospective customer before establishing the letter of credit. The due diligence should include gathering sufficient information on Applicants and Beneficiaries, including their identities, nature of business, and sources of funding. This may require the use of background checks or investigations, particularly in higher-risk jurisdictions. As such, banks should conduct a thorough review and reasonably know their customers prior to facilitating trade-related activity and should have a thorough understanding of trade finance documentation. Refer to the core overview section, "Customer Due Diligence," page 56, for additional guidance.

Likewise, guidance provided by the Financial Action Task Force on Money Laundering (FATF) has helped set important industry standards and is a resource for banks that provide trade finance services.<sup>242</sup> The Wolfsberg Group also has published suggested industry standards and guidance for banks that provide trade finance services.<sup>243</sup>

Banks taking other roles in the letter of credit process should complete due diligence that is commensurate with their roles in each transaction. Banks need to be aware that because of the frequency of transactions in which multiple banks are involved, Issuing Banks may not always have correspondent relationships with the Advising or Confirming Bank.

To the extent feasible, banks should review documentation, not only for compliance with the terms of the letter of credit, but also for anomalies or red flags that could indicate unusual or suspicious activity. Reliable documentation is critical in identifying potentially suspicious activity. When analyzing trade transactions for unusual or suspicious activity, banks should consider obtaining copies of official U.S. or foreign government import and export forms to assess the reliability of documentation provided.<sup>244</sup> These anomalies could appear in shipping documentation, obvious under- or over-invoicing, government licenses (when required), or discrepancies in the description of goods on various documents. Identification of these elements may not, in itself, require the filing of a SAR, but may suggest the need for further research and verification. In circumstances where a SAR is warranted, the bank is not expected to stop trade or discontinue processing the transaction. However, stopping the trade may be required to avoid a potential violation of an OFAC sanction.

Trade finance transactions frequently use Society for Worldwide Interbank Financial Telecommunication (SWIFT) messages. U.S. banks must comply with OFAC regulations, and when necessary, licensing in advance of funding. Banks should monitor the names of the parties contained in these messages and compare the names against OFAC lists. Refer to

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<sup>242</sup> Refer to the Financial Action Task Force's report on [Trade Based Money Laundering](#), June 23, 2006 and the [Asia Pacific Group Typology Report on Trade Base Money Laundering](#), July 20, 2012.

<sup>243</sup> Refer to [The Wolfsberg Trade Finance Principles](#), 2011.

<sup>244</sup> For instance, refer to [U.S. Customs and Border Protection Form 7501 \(Entry Summary\)](#) and U.S. Department of Commerce Form 7525-V (Shipper's Export Declaration) classify all U.S. imports and exports by 10-digit harmonized codes.

overview section, “Office of Foreign Assets Control,” page 142, for guidance. Banks with a high volume of SWIFT messages should determine whether their monitoring efforts are adequate to detect suspicious activity, particularly if the monitoring mechanism is not automated. Refer to core overview section “Suspicious Activity Reporting,” page 60, and expanded overview section, “Funds Transfers,” pages 207, for additional guidance.

Policies, procedures, and processes should also require a thorough review of all applicable trade documentation (e.g., customs declarations, trade documents, invoices, etc.) to enable the bank to monitor and report unusual and suspicious activity, based on the role played by the bank in the letter of credit process. The sophistication of the documentation review process and MIS should be commensurate with the size and complexity of the bank’s trade finance portfolio and its role in the letter of credit process. In addition to OFAC filtering, the monitoring process should give greater scrutiny to:

- Items shipped that are inconsistent with the nature of the customer’s business (e.g., a steel company that starts dealing in paper products, or an information technology company that starts dealing in bulk pharmaceuticals).
- Customers conducting business in higher-risk jurisdictions.
- Customers shipping items through higher-risk jurisdictions, including transit through noncooperative countries.
- Customers involved in potentially higher-risk activities, including activities that may be subject to export/import restrictions (e.g., equipment for military or police organizations of foreign governments, weapons, ammunition, chemical mixtures, classified defense articles, sensitive technical data, nuclear materials, precious gems, or certain natural resources such as metals, ore, and crude oil).
- Obvious over- or under-pricing of goods and services.
- Obvious misrepresentation of quantity or type of goods imported or exported.
- Transaction structures that appear unnecessarily complex and designed to obscure the true nature of the transaction.
- Customer directs payment of proceeds to an unrelated third party.
- Shipment locations or description of goods not consistent with letter of credit.
- Significantly amended letters of credit without reasonable justification or changes to the beneficiary or location of payment. Any changes in the names of parties also should prompt additional OFAC review.

On February 18, 2010, FinCEN issued an advisory to inform and assist the financial industry in reporting instances of suspected trade-based money laundering (TBML)<sup>245</sup>. The advisory contains examples of “red flags” based on activity reported in SARs that FinCEN and law enforcement believe may indicate trade-based money laundering. In order to assist law

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<sup>245</sup> [Advisory to Financial Institutions on Filing Suspicious Activity Reports regarding Trade Based-Money Laundering](#), FIN-2010-A001, February 18, 2010.

enforcement in its effort to target TBML and black market peso exchange (BMPE) activities, FinCEN requested in the advisory that financial institutions check the appropriate box in Part II, Suspicious Activity Information section of the SAR and include the abbreviation TBML or BMPE in the narrative section of the SAR. The advisory can be found on the [FinCEN Web site](#).

Unless customer behavior or transaction documentation appears unusual, the bank should not be expected to spend undue time or effort reviewing all information. The examples above, particularly for an Issuing Bank, may be included as part of its routine CDD process. Banks with robust CDD programs may find that less focus is needed on individual transactions as a result of their comprehensive knowledge of the customer's activities.