15: Trade finance

Note: This sectoral guidance is incomplete on its own. It must be read in conjunction with the main guidance set out in Part I of the Guidance Note.

Firms addressing the money laundering/terrorist financing risks in trade finance should also have regard to the guidance in Sector 16: Correspondent Relationships.

Overview of the sector

15.1 'Trade Finance' is used to describe various operations, including the financing – usually but not exclusively by financial institutions - undertaken to facilitate trade or commerce, which generally involves the movement of goods and/or services between two points – it can therefore be domestic or international. The trade finance element may only be part of the overall financial component and may have multiple variations, e.g., a domestic trade finance transaction could support an international movement of goods, or on occasion only services may be involved (see paragraph 15.9: Funds transmission/payments). Such operations comprise a mix of money transmission instruments, default undertakings and provision of finance, which are described in more detail below. A glossary of trade finance terms used in this guidance is set out in Annex 15-I.

15.2 In the context of this guidance, the term 'Trade Finance' is used to refer to the financial component of an international trade transaction, i.e., managing the payment for goods and/or related services being imported or exported. Trade finance activities may include issuing letters of credit, standby letters of credit, and bills for collection or guarantees. Trade Finance operations are often considered in a cross-border context but can also relate to domestic trade.

15.3 Past estimates suggest that approximately only a fifth of global trade involves the use of trade finance products and services to support transactions. The rest of the trading activity is conducted on "Open Account" terms, whereby a 'clean' payment is made by the buyer of the goods or services direct to the seller, i.e. not requiring presentation of the supporting trade documentation to the banks through which the payment is effected. It follows that whenever credit and liquidity are scarce or trust between the transacting parties has not been established, sellers in particular will be inclined to revert to Trade Finance.

15.4 In Open Account transactions, unlike transactions where trade finance products and services are used, the firm is only aware of the payment and will not be aware of the reason for the payment, unless the relevant details are included in the associated SWIFT messages. Firms will therefore be able to carry out sanctions screening only on the payment, with anti-money laundering checks achieved to the extent practicable by its risk-based transaction monitoring. Where credit is being provided, however, the firm may have more information to enable it to understand the reasons for the transaction and the financial movements. The inherent risk and residual risk of trade finance products and services may vary greatly in this context, as transaction control frameworks are often applied to trade finance business by firms as an industry standard to mitigate inherent risks. Firms are not required to investigate commercial transactions outside their knowledge, although if documentation they see as part of a banking transaction gives rise to suspicion, they must submit a SAR to the NCA, and may seek consent/a defence against money laundering (DAML), as appropriate.

15.5 The primary focus of this guidance is on those standard products used for the finance of the movement of goods or services across international boundaries. The products are:

- Documentary Letters of Credit (LCs);
- Documentary Bills for Collection (BCs), and
- Demand Guarantees and Standby Letters of Credit (Default Undertakings)

See Annex 15-I for detailed definitions of these products.

These standard products (in the case of LCs and BCs) usually have trade related documents (invoices, transport documents etc) that are sent through firms and are examined by documentary checkers within the firm for consistency with the terms of the trade transaction. In the case of LCs, this would include ensuring that the information remains consistent with what was originally approved and in the case of BCs this would include screening documents for AML/CTF and sanctions compliance purposes to ensure that the transaction remains within the firm's risk appetite. Such operations are illustrated (in simple terms) in Annex 15-II and are described in more detail below.

15.6 These products are governed by internationally recognised sets of rules issued by or with the support and approval of the International Chamber of Commerce (ICC). When carrying out financial crime risk management checks, financial institutions also need to comply with the standard international banking practices that these rules have created. Each set of rules is specific to the product that it covers.

15.7 International trade finance transactions will usually involve financial institutions in different locations, acting in a variety of capacities. For the purpose of LCs these may include an Issuing Bank, an Advising Bank, Nominated Bank, Confirming Bank or Reimbursing Bank. For BCs there will be a Remitting, Collecting or Presenting Bank. The nature of the capacity in which a financial institution may be involved is important, as this will dictate the nature and level of information available to the financial institution in relation to the underlying exporter/importer, the nature of trade arrangements and transactions. The fragmented nature of this process, in which a particular financial institution may of necessity have access only to limited information about a transaction, means that it may not be possible for any one financial institution to devise hard coded rules or scenarios, or any patterning techniques in order to implement a meaningful transaction monitoring system for the whole transaction chain.

15.8 The main types of trade finance operations are described in more detail below. Whilst they are addressed separately, they are not necessarily mutually exclusive and these operations may be combined in relation to a single transaction, series of transactions or, on occasion, in relation to a particular project. In terms of assessing risk, it is important to understand the detailed workings of individual operations/financial instruments, rather than automatically assuming that they fit into a particular category simply because of the name that they may have been given.

Funds Transmission/Payments

15.9 Trade finance operations often involve transmission of funds where the payment is subject to presentation of document(s) and/or compliance with specified condition(s). Financing may on occasion be provided either specifically related to the instrument itself, or as part of a general line of credit.

Default Undertakings

15.10 As the term implies, such undertakings normally only involve payment if some form of default has occurred. Typical undertakings in this category are bonds, guarantees, indemnities and standby letters of credit. Provision of finance is less common than with funds

transmission/payment instruments, but could also occur.

Structured Trade Financing

15.11 This category comprises a variety of financing techniques, but with the common aim of facilitating trade and commerce, where financing is the primary operation, with any associated Trade Finance products and services and/or undertaking being secondary. On occasion, such financing may be highly complex e.g., involving special purpose vehicles (SPVs). Finance may be provided against evidence of performance under a trade contract, often on a staged basis that represents progress in that contract.

What are the financial crime risks in Trade Finance?

General

15.12 A key risk around trade finance business is that seemingly legitimate transactions and associated documents can be constructed simply to justify the movement of funds between parties, or to show a paper trail for non-existent or fraudulent goods. In particular, the level and type of documentation received by a firm is dictated principally by the applicant or instructing party, and, because of the diversity of documentation, firms may not be expert in many of the types of the documents used within trade finance transactions (although experienced trade finance staff should have a good understanding of the most commonly used types of document). Such a risk is probably greatest where the parties to an underlying commercial trade transaction are in league to disguise the true nature of a transaction. In such instances, methods used by criminals to transfer funds illegally range from over and under invoicing, to the presentation of false documents or spurious calls under default instruments. In more complex situations, for example where asset securitisation is used, trade receivables can be generated from fictitious parties or fabricated transactions (albeit the use of asset securitisation in trade finance is a very limited activity). The use of copy documents, particularly documents of title, should be discouraged, and should raise a due diligence query, except where the location of the original documents (of title) and the reasons for their absence is disclosed to and acceptable by the banks in the transaction. Banks should implement additional safeguards with respect to related party transactions, e.g. requiring further escalation and scrutiny, requesting documentary evidence to verify the authenticity, and understand the role of the related party(ies) in the transaction.

A non-exhaustive list of broad financial crime red flag risk factors relating to transactions, customers, documents, payments and shipments is included in Annex 15-IV. These may be identifiable during the normal course of business involving trade finance products. The focus is on money laundering and terrorist financing, but they may indicate other predicate offences involving bribery, corruption, tax evasion and fraud. A red flag risk factor should be treated as a possible increased risk prompting further enquiries and assessment.

15.13 A form of trade finance is generally used instead of clean payments and generic lending to provide additional protection for the commercial parties and independent and impartial comfort when parties require some level of performance and payment security or when documentation is required for other purposes e.g., to comply with Customs, other regulatory requirements, control of goods and/or possible financial institution requirements. The key money laundering/terrorism risks arise when such documentation is adapted to facilitate non-genuine transactions, normally involving movement of funds at some point.

15.14 The Financial Action Task Force (FATF), regulators and others have identified misuse of the trade system as one of the methods by which criminal organisations and terrorist financiers move money for the purpose of disguising its origins and integrating it into the legitimate

economy. FATF typologies' studies indicate that criminal organisations and terrorist groups exploit vulnerabilities in the international trade system to move value for illegal purposes. Cases identified included: illicit trafficking in narcotic drugs; illicit trafficking in stolen or other goods; corruption and bribery; fraud; counterfeiting/piracy of products; and smuggling. More complicated schemes integrate these fraudulent practices into a complex web of transactions and movements of goods and money.

Money laundering risk

15.15 Given the nature of the business, there is little likelihood that trade finance will be used by money launderers in the placement stage of money laundering. However, trade finance can be used in the layering and integration stages of money laundering as the enormous volume of trade flows obscure individual transactions and the complexities associated with the use of multiple foreign exchange transactions and diverse trade financing arrangements permit the commingling of legitimate and illicit funds.

15.16 FATF's June 2006 study of Trade Based Money Laundering[1] defined trade-based money laundering as "the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimise their illicit origins. In practice, this can be achieved through the misrepresentation of the price, quantity or quality of imports or exports. Moreover, trade-based money laundering techniques vary in complexity and are frequently used in combination with other money laundering techniques to further obscure the money trail". The study concludes that "trade-based money laundering represents an important channel of criminal activity and, given the growth in world trade, an increasingly important money laundering and terrorist financing vulnerability. Moreover, as the standards applied to other money laundering techniques become increasingly effective, the use of trade-based money laundering can be expected to become increasingly attractive". The term 'trade transactions' as used by the FATF is wider than the trade transactions described in this sectoral guidance.

15.17 FATF's June 2006 study notes that the basic techniques of trade-based money laundering include:

- **Over Invoicing:** by misrepresenting the price of the goods in the invoice and other documentation (stating it at above the true value) the seller gains excess value as a result of the payment[2].
- **Under invoicing:** by misrepresenting the price of the goods in the invoice and other documentation (stating it at below the true value) the buyer gains excess value when the payment is made.
- **Multiple invoicing:** by issuing more than one invoice for the same goods a seller can justify the receipt of multiple payments. This will be harder to detect if the colluding parties use more than one financial institution to facilitate the payments/transactions.
- **Short shipping:** the seller ships less than the invoiced quantity or quality of goods thereby misrepresenting the true value of goods in the documents. The effect is similar to over invoicing
- **Over shipping:** the seller ships more than the invoiced quantity or quality of goods thereby misrepresenting the true value of goods in the documents. The effect is similar to under invoicing.
- **Deliberate obfuscation of the type of goods:** parties may structure a transaction in a way to avoid alerting any suspicion to financial institutions or to other third parties which

[1] http://www.fatf-gafi.org/publications/methodsandtrends/documents/trade-basedmoneylaundering.html.pdf

[2] A report by Global Financial Integrity showed there was an estimated average of $725billion to $810 billion per annum in illicit financial flows from Developing Countries between 2000 and 2009. Of these amounts, 55% was due to trade mispricing. See http://iff-update.gfip.org/

become involved. This may simply involve omitting information from the relevant documentation or deliberately disguising or falsifying it. This activity may or may not involve a degree of collusion between the parties involved and may be for a variety of reasons or purposes.

- **Phantom Shipping:** no goods are shipped, and all documentation is completely falsified.

15.18 Generally, these techniques depend upon collusion between sellers and buyers, since the intended outcome of the trade is to obtain value in excess of what would be expected from an arms' length transaction, or to move funds from point A to point B without being detected or accounted for by the authorities. The collusion may arise, for example, because the parties are controlled by the same persons, or because the parties are attempting to evade taxes on some part of the transaction. These techniques also often involve fraud by one party against another.

15.19 Some countries require that for the importation of certain types of goods, independent inspection agents certify that the goods meet the specified quality standards and that the prices charged are appropriate. The buyer and seller may also agree to use inspection agents, who will issue a certificate confirming the quality and may include price.

Sanctions/proliferation financing/dual use goods

15.20 There is at present no agreed definition of proliferation or proliferation financing. FATF's Working Group on Terrorist Financing and Money Laundering has proposed the following definition of proliferation financing for the purposes of its work:

> *[Proliferation financing is] the act of providing funds or financial services which are used, in whole or in part, for the manufacture, acquisition, possession, development, export, trans-shipment, brokering, transport, transfer, stockpiling or use of nuclear, chemical or biological weapons and their means of delivery and related materials (including both technologies and dual-use goods used for non-legitimate purposes), in contravention of national laws or, where applicable, international obligations*[3].
>
> ***[Combating Proliferation Financing:* A Status Report on Policy Development and Consultation *- February 2010]***

This report analysed the risks and possible policy responses. Annex 15-III reproduces the report's discussion on how various types of entity in the financial sector might become involved in proliferation activities.

FATF released a further paper in February 2018 outlining its non-binding guidance to facilitate both public and private sector stakeholders in understanding and implementing their obligations pertaining to proliferation financing.

15.21 Dual-use goods are items that have both commercial and military or proliferation applications. This can include goods that are components of a weapon, or those that would be used in the manufacture of a weapon (*e.g.,* certain machine tools that are used for repairing automobiles can also be used to manufacture certain component parts of missiles).

15.22 Dual-use goods destined for proliferation use are difficult to identify, even when detailed information on a particular good is available. Regardless of the amount of information provided for a particular good, highly specialised knowledge and experience is often needed to determine if a good may be used for proliferation. Dual-use items can be described in

[3] The definition of an *act* of proliferation financing need not involve knowledge. However, when considering the responsibilities of financial institutions or a possible criminal basis of proliferation financing, a subjective element will be indispensable.

common terms with many uses – such as “pumps” – or in very specific terms with more specific proliferation uses – such as metals with certain characteristics. Further, many goods are only regarded as dual use if they meet very precise performance specifications. The ICC issued a policy statement on financial crime checks on dual use goods.[4]

15.23 Proliferation differs from money laundering in several respects. The fact that proliferators may derive funds from both criminal activity and/or legitimately sourced funds means that transactions related to proliferation financing may not exhibit the same characteristics as conventional money laundering. Furthermore, the number of customers or transactions related to proliferation activities is likely to be markedly smaller than those involved in other types of criminal activity such as money-laundering.

15.24 There are a variety of United Nations (UN), UK and regional sanctions in place. These include:

- Country-based financial sanctions that target specific individuals, bodies and entities
- Trade-based sanctions, e.g., embargos on the provision of certain goods, services or expertise to certain countries
- Sectoral sanctions: a comprehensive set of sanctions introduced by the UK, EU and the US aimed at certain industry sectors (financial services, energy, mining and defence) and prohibiting certain types of transactions primarily with a new debt/equity issuance nexus. The applications of such sanctions can be very complex in nature as all aspects of the trade finance transaction should be considered in determining whether it might give rise to a breach. It should be noted that entities designated within sectoral sanctions regimes are not subject to asset freeze.

There has also been a series of UN Security Council Resolutions which have, inter alia, introduced targeted financial sanctions and/or activity-based financial prohibitions in respect of certain countries which relate to the prevention of chemical, biological, radiological and nuclear (CBRN) weapons proliferation. For further guidance, firms should refer to the Office of Financial Sanctions Implementation’s (OFSI) Guidance on financial sanctions[5].

15.25 Compliance with the sanctions in force within jurisdictions is relevant to all the products and services offered by firms. Sanctions that require the embargo of certain goods and services have particular relevance in relation to the provision and facilitation of trade finance products.

15.26 Should a firm need to apply for a licence to conduct a trade finance transaction that may otherwise be prohibited by an asset freeze or embargo, the firm will require a written authorisation from OFSI. Further guidance on sanctions compliance may be found in Part III and in OFSI Guidance.

15.27 The use of trade finance to breach sanctions and/or for the proliferation of CBRN weapons could potentially take advantage of the complex and fragmented nature of existing global finance activity where multiple parties (in many cases with limited knowledge of one another) become involved in the handling of trade finance.

Assessing the trade-based financial crime risk

15.28 A firm's risk-based approach should be designed to ensure that it places an emphasis on deterring, detecting and disclosing in the areas of greatest perceived vulnerability, in order to counter to the extent practicable, the above trade-based money laundering, terrorist financing

[4] https://iccwbo.org/content/uploads/sites/3/2019/06/icc-policy-statement-financial-crime-compliance-checks-on-the-price-of-goods.pdf
[5] https://www.gov.uk/government/publications/financial-sanctions-faqs

and proliferation financing techniques.

15.29 Firms should pay particular attention to transactions which their own analysis and risk policy have identified as high risk and make further enquiries and/or obtain further information as appropriate.

15.30 Firms should be aware of the findings in the FCA's thematic review of banks' trade finance activities published in July 2013 (see https://www.fca.org.uk/publication/thematic reviews/tr-13-03.pdf), and further useful information on trade finance may also be found in the Wolfsberg Group, ICC & BAFT - Trade Finance Principles 2019 (see https://wolfsberg-principles.com/wolfsberg-group-standards).

Money laundering/terrorist financing

15.31 The ability of a firm to assess the money laundering/terrorist financing risks posed by a particular transaction will depend on the amount of information that it has about that transaction and the parties to it. This will be determined by the firm's role in the Trade Finance operation. The amount of information available to a firm may vary depending on the size/type of the firm and the volume of business that it is handling. Where possible when assessing risk, firms must take into consideration the parties involved in the transaction and the countries where they are based, as well as the nature of any goods forming the basis of an underlying commercial transaction.

15.32 Apart from direct information, firms should have regard to public sources of information that are available at no or minimal direct cost, such as those available on the internet. For example, firms may validate bills of lading by reference to the websites of shipping lines, many of whom offer a free facility to track movements of vessels and containers. By using the unique container reference number, firms may be able to confirm that the container was loaded on a designated vessel and that vessel is undertaking the claimed voyage, or validate the unique number. The websites of many shipping lines provide details of the current and future voyages being undertaken by their ships and up to date information regarding their precise location. Firms would not be expected to investigate commercial transactions outside of their knowledge, although naturally if documentation they see as part of the banking transaction gives rise to suspicion, this should be reported. For non-containerised transactions including commodity trades, the vessel can be tracked by its unique International Maritime Organisation (IMO) number using freely available websites.

15.33 When developing a risk-based strategy firms should consider, but not restrict their consideration to, factors such as the size of the transaction, nature of the transaction, geographical location of the parties and the customer's business mix. Firms are required to undertake periodic assessments of the money laundering and terrorist financing risks (See Part I Chapter 4.11-4.23). When carrying out an enterprise-wide risk assessment (EWRA), firms should further consider the following from an inherent risk perspective:

- Correspondent Relationships for Trade Finance – The nature and scale of the risks that arise through correspondent relationships (See 15.42-15.44) maintained for the purposes of supporting trade finance activities with other international financial institutions.
- Non-customer third parties – The risk exposure to non-customer 3rd parties, either via trade finance clients or transactions. These may include, but are not limited to, applicants, beneficiaries, brokers, intermediaries, introducers, vessels, ports, money service businesses (MSBs), other non-financial businesses and professions, including professional trustees, legal professionals and financial advisors.

- Types of Commodities/Traded Items – The risk exposure to facilitating trade (via trade finance clients or transactions) of certain types of commodities or items that indicate potentially increased risk. These include, for example, oil; arms; precious metals. See Part I Chapter 4 Annex 4-II for further detail and definitions.
- Supply Chain – The risk exposure from a firm's client's customer base, e.g. buyers or suppliers of a customer. There may be an increased risk from the counterparties of a client who sources goods from developing markets/sanctioned countries and/or who sells goods to such countries.

15.34 Firms need to be aware of trade-based money laundering techniques when developing their risk-based strategy and consider how best to mitigate the risks to themselves.

15.35 In certain specific, highly structured transactions firms should exercise reasonable judgment and consider whether additional investigation should be undertaken. Such investigation may include determining whether over-invoicing or under-invoicing, or any other misrepresentation of value, may be involved, which cannot usually be based solely on the trade documentation itself. Nor can the use of external data bases alone be relied upon as most products are not traded in public markets and have no publicly available prices. Even where such prices are available, such as those for commodities, firms will not be aware of the terms of trade, discounts involved or quality of the goods etc, so making a determination of the unit pricing will often be difficult. However, where the unit price of goods is materially different from the current market value, firms should consider whether they have a suspicion and whether they should accordingly submit a SAR to the NCA.

Proliferation financing

15.36 Particular issues arise in relation to possible proliferation financing risks presented by customers and products, and these are outlined in Annex 15- IV.

Customer due diligence (CDD)

General

15.37 CDD must be undertaken on the customer who is the instructing party for the purpose of the transaction, before the transaction. Reference to Part I, Chapter 5 and Part II Sector 16 should be made as appropriate. Due diligence on other parties, and on the transaction itself, should be undertaken in line with the firm's risk-based approach.

Who is the customer and who are the relevant 3rd parties?

15.38 The following table outlines the parties on whom CDD must be conducted, or on whom other due diligence should be conducted. The list is not exhaustive and where necessary firms will need to decide in each case who the instructing party is and who the other relevant parties are.

Figure 1

Product Type	Product sub-type	Firm acting as:	Instructing Party/Customer[6]/ Correspondent banking relationship with applicable Bank (See 15.42-15.44)	Relevant 3rd Parties (See para 15.40)
Documentary Letters of Credit (LCs)	Import LC	Issuing Bank	Applicant/Buyer/ Importer	Beneficiary/Seller/Exporter Advising Bank
	Export LC	Advising and/or Nominated Bank	Issuing Bank/Applicant Bank	Beneficiary/Seller/Exporter Applicant
Documentary Bills of Collection (BCs)	Outward Collections	Remitting Bank/Principal's Bank	Principal/Exporter/ Drawer/Seller Collecting Bank/ Presenting Bank	Importer/Drawee/Buyer
	Inward Collections	Collecting Bank/Presenting Bank	Importer/Drawee/ Buyer Remitting Bank/ Principal's Bank	Exporter/Drawer/Seller
Demand Guarantees	Issuance	Guarantor	Applicant	Beneficiary
	Issuance against Counter Guarantee	Counter Guarantor	Issuing Bank/Instructing Bank	Beneficiary Applicant
Standby Letter of Credit (SBLC)	Issuance/Issuance against Counter SBLC	Issuing Bank	Applicant/Instructing Bank	Beneficiary Applicant (if issued against Counter SBLC)
	Export (Inward) SBLC	Advising and/or Confirming Bank	Issuing/Instructing Bank	Beneficiary/Seller/Exporter Applicant

[6] In certain cases the Customer may take the form of a 'Master' *Instructing Party/Applicant* granting the instruction and/or assignment of LC applications, issuance of guarantees & SBLCs (generally through a contractual credit facility agreement) and/or documentary collections to other subsidiary sub-applicants across a wider operating corporate group. In such cases, and where the sub-applicant(s) are >50% beneficially owned, controlled and consolidated subsidiaries of a Master Applicant which is the firm's customer; the applicable due diligence on sub-applicants may follow that of a relevant 3rd party.

Note: The following parties may also be involved:

Transferor: This would be the Beneficiary of a transferable/applicant of the transferred LC, Demand Guarantee or SBLC and the applicant of the transferred LC, Demand Guarantee or SBLC. The Beneficiary here would be instructing the firm and CDD is required.

Transferee: This would be a third party who should be considered a relevant 3rd party for due diligence purposes by the transferring bank and the Beneficiary by the Advising Bank of the transferred LC, Demand Guarantee or SBLC.

Assignor: This would be the Beneficiary of the LC, Demand Guarantee or SBLC who gives notice of the assignment of its right to receive some or all proceeds of the relevant instrument. Such an assignment would typically be in favour of a supplier of the Beneficiary (see Assignee). The Assignor should be considered a relevant 3rd party by the Advising Bank.

Assignee: This would be a third party who should be considered a relevant 3rd party by the Advising Bank of the transferred LC, Demand Guarantee or SBLC.

Risk based due diligence

15.39 When conducting CDD the following should be considered on a risk-based approach in line with the firm's internal risk policy:

- Whether there is an existing relationship with the customer that will be subject to a risk-based review cycle.
- Whether the proposed transaction is in line with the expected nature and purpose of the customer.
- The countries in which the customer trades or does business in and the trade routes utilized.
- The goods traded (including their origin and export licence requirements)
- The ability to authenticate the LC received from the issuing bank (where applicable).
- The level of due diligence to be carried out on other 3rd parties.
- The types, nature and location of other parties with whom the customer does business or is involved with within the trade or business activity.

Relevant 3rd party due diligence (refer to Figure 1 above)

15.40 Although relevant 3rd parties identified within a proposed transaction are not customers and may not have a business relationship with the firm, the firm should satisfy themselves, on a risk-based approach, that those 3rd parties do not pose any additional financial crime risk. Firms should consider performing some checks on these parties, including for example:

- Evidence of legal existence
- Screening against relevant sanctions and embargoes list
- Screening for adverse media on a risk-based approach
- Rationale for involvement in the trade or activity.

Other related 3rd parties

15.41 Apart from screening processes which should be applied on the basis of international sanctions regimes, firms may also wish to apply their own risk based due diligence on a case-by-case basis on the following other related 3rd parties:

- Suppliers (of the producer/manufacturer)
- Agents
- Freight forwarders
- Insurance providers
- Vessels
- Shippers/carriers

Correspondent Banking Relationships for Trade Finance

15.42 A correspondent banking relationship for trade finance arrangements is formed where the firm provides trade finance products/services to a respondent financial institution and where transactions are ongoing and repetitive in nature [7]. These trade finance products/services, include:

- the advising or confirming of an Export (inward) LC;
- the issuance of a guarantee or SBLC or;
- the handling of a BC (inward or outward)

A relationship which is ongoing and repetitive in nature would involve one or more of the above types of trade finance products/services being undertaken as a series of transactions close in chronology. In these situations, firms must undertake EDD on the respondent financial institution as outlined in Part II, Sector 16.28-16.29.

15.43 In other circumstances, where a banking relationship for trade finance arrangements is entered into on an occasional basis and not as per 15.42, firms should document their rationale for making the distinction, including having regard to whether EDD is nevertheless required (see also 15.57).

In addition to the above considerations, firms should:

- perform risk based due diligence on the documents obtained to evidence the underlying transaction(s);
- ensure that they understand the related counterparties prior to transacting; and
- be aware of any red flag risk factors that require further enquiries and/or EDD.

15.44 Firms must ensure that there are adequate and effective controls to monitor whether and/or when a correspondent banking relationship for trade finance is formed, whereupon paragraph 15.42 is applicable.

[7] *FATF Guidance – Correspondent Banking Services (October 2016) - Section II Definitions (13)(a) (Link: http://www.fatf-gafi.org/media/fatf/documents/reports/Guidance-Correspondent-Banking-Services.pdf)*

Sanctions/counter proliferation financing compliance

15.45 The ability of firms to implement activity-based controls against proliferation is limited, due to the lack of technical expertise of firms, the limited information available as a basis for such controls and firms' inability to examine whether such information is correct; the structural differences between money laundering and proliferation financing and the lack of clear financial patterns uniquely associated with proliferation financing; and the fragmented nature of the trade cycle, which limits each firm's visibility of the whole transaction.

15.46 *Targeted financial sanctions*[8] provide firms with proliferation-related information on which they can take action. Targeted financial sanctions are considered to be most effective when they are implemented globally i.e. by the UN, since a designated entity cannot as easily turn to third-country firms to evade sanctions.

15.47 Some jurisdictions have established their own capability to impose targeted financial sanctions on individuals and entities they deem involved in WMD proliferation, independent of sanctions agreed by the UN Security Council. The European Union (EU) has also adopted such sanctions based on specific legislation relating to certain countries of specific proliferation concern.

15.48 Targeted financial sanctions may also prompt a proliferation-related entity to conceal its involvement in a transaction. This may involve the use of unusual financial mechanisms which may arouse suspicion among legitimate exporters, or patterns of activity which may generate suspicion of money laundering.

15.49 Where lists of entities are available, firms should consider whether undertaking real-time screening of transactions is appropriate. Lists of entities in this context could potentially include both entities subject to targeted financial sanctions e.g., UNSCR 1737, under which transactions with named entities are prohibited; as well as (if such lists are made available), entities of proliferation concern, which have been identified as high-risk by competent authorities and which could be subject to enhanced due diligence and/or suspicious activity reporting. Firms should be careful not unintentionally to treat all types of lists as financial sanctions lists, thus running the risk of prohibiting business with these entities and jurisdictions altogether. Real-time screening against listed entity-names has limitations, however, and may be evaded if the listed entity changes its name or operates through a non-listed front company.

15.50 Alternative approaches would be required to identify and prevent proliferation financing activity conducted by non-listed entities. These could include both manual systems – enhanced due diligence, increased monitoring, and enhanced frequency of relationship reviews – and automatic systems such as post-event monitoring of account activity.

15.51 Post event monitoring, using multiple risk indicators, may have the potential to identify proliferation financing activity.

15.52 *Goods based screening*; evaluation of the goods involved in a transaction very often requires a large amount of technical knowledge only available to export controls experts and/or exporters. Goods lists pose a tremendous challenge even for export control enforcement and certainly a greater one for real time screening than entity lists. Furthermore, firms in general lack the expertise to discriminate between legitimate and proliferation-sensitive goods. Goods lists, in themselves, should not be used as a basis for transaction screening, as their limited effectiveness, and greater difficulty, make them an inefficient safeguard. [9]

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[8] For the purposes of this guidance, "targeted financial sanctions" includes not only asset freezing, but also prohibitions to prevent funds from being made available to "designated" or "listed" persons and entities.

[9] www.ecochecker.trade.gov.uk is a useful tool)

Financial institutions are expected to perform sanctions screening both at the inception of the trade finance transaction and at the point of submission of the trade finance documents, as some of the transactional details, (e.g. vessels, ports of call etc), may not be known at trade inception and also there could be subsequent updates to the sanctions lists.

Forfaiting

15.53 The diverse nature of forfaiting business is such that the exact nature of the transaction needs to be considered. For example, the need to ensure authenticity may lead to enquiries being made of the importer's management, and it may be necessary to examine the commercial parts of documents, dependent on the nature of the underlying commercial transaction.

15.54 In the primary Forfaiting, or origination, market, a firm will usually be dealing directly with an exporter, who will be its customer and on whom it should carry out due diligence in accordance with Part I, Chapter 5. In addition, as part of its risk-based approach, a firm, where appropriate, should scrutinise the other party to the underlying commercial transaction, as well as the transaction itself, to satisfy itself of the validity of the transaction. The amount and depth of scrutiny will depend on the firm's risk assessment of the client and transaction.

15.55 In the secondary Forfaiting market, the firm's customer will be the person from whom it buys the evidence of debt. However, if it holds a Forfait asset to maturity it will be receiving funds from the guarantor bank and thus it should as a matter of course perform due diligence on this entity as well. Using a risk-based approach, firms should also consider whether they should conduct some form of due diligence on the underlying parties to the transaction, as well as on the transaction itself. This will depend on a risk assessment of the countries and the types of clients or products and services involved. It may be necessary to examine documentation on the underlying commercial transaction. However, it should be borne in mind that the further away from the original transaction the purchaser of a Forfait asset is, the harder it will be to undertake meaningful due diligence.

Structured Trade Financing

15.56 As stated above, structured trade finance transactions are diverse in nature. CDD must be undertaken on the firm’s customer (see also Part I Chapter 5) and risk based due diligence should be performed on all relevant parties in accordance with the firm's own risk policy/assessment, including, where relevant, certificate(s) of origin to establish the origin of commodities (for example, crude oil).

Enhanced due diligence (EDD)

15.57 A firm must apply risk sensitive EDD measures on its customer in any situation which by its nature can present a higher risk of money laundering or terrorist financing (See Part 1, Chapter 5.5 for further guidance). In addition, where the nature of a specific trade finance transaction displays red flag risk factors (refer to Annex 15-IV), the firm should consider undertaking additional measures and/or making further enquiries in line with its risk policies. Examples of such additional measures/further enquiries may include but are not limited to:

- make enquiries as appropriate into the ownership and background of the other parties to the transaction e.g., the beneficiary(ies), including additional payment beneficiaries where an assignment of proceeds has been requested, agents, shipping lines, freight forwarders etc, and taking further steps to verify information or the identity of key individuals as the case demands;
- seek information from the instructing party about the frequency of trade and the quality of the business relationships existing between the parties to the transaction. This should be documented to assist future due diligence;
- check that the goods and transaction are compatible with the business activity of both the importer and exporter and makes economic sense;
- check the transaction against warning notices from external public sources, for example the ICC's International Maritime Bureau;
- refer the transaction to external agencies specialising in search and validation services in respect of bills of lading, shipping services and commodity prices, for example the ICC Commercial Crime Services;
- check details of the origin of goods;
- obtain an export licence from the exporter where the goods are confirmed as dual use;
- check public source information for prices of goods such as commodities – where the contract price is significantly different from the market benchmark then consider further investigation;
- make additional enquiries which may include attending and recording relationship meetings with the instructing party;
- for export letters of credit, refer details to other Group resources on the ground in the country of origin, to seek corroboration.
- checks into the verification of shipments after the transactions, drawn at random from a sample of transactions, across a cross section of the bank's trade finance clients. This may help to identify spurious transactions where buyers and sellers act in collusion.

15.58 The EDD should be designed to understand the nature of the transaction, the related trade cycle for the goods involved, the appropriateness of the transaction structure, the legitimacy of the payment flows and what control mechanisms exist.

15.59 The nature of business and the anticipated transactions as described and disclosed in the initial due diligence stage may not necessarily suggest a higher risk category but if, during the course of any transaction any high-risk factors become apparent, this may warrant additional due diligence. For example – although these may be used legitimately - where third party middlemen or traders use back-to-back or transferable LCs to conclude offshore deals, or where the buyer is itself a middleman or trader.

Risk Mitigation: Internal Controls and Monitoring

15.60 Firms should have regard to the general guidance set out in Part I, section 5.7 on monitoring and in Chapter 6, on reporting suspicious transactions, and requesting consent where appropriate. The depth and frequency of monitoring to be undertaken will be determined by a firm's risk analysis of the business and/or the parties involved. Firms should, however, implement such controls and procedures appropriate to their business, but in any event must comply with any applicable legal or regulatory requirements.

15.61 Firms should also carry out regular assessments of the adequacy and effectiveness of their systems to ensure that they manage their financial crime risks effectively, which include those for trade-based money laundering.

15.62 Firms may refer to sources of information that may be relevant to assessing the risk that particular goods may be 'dual-use', or otherwise subject to restrictions on their movement. For

example, there are public resources (such as the EC's TARIC database) that can indicate which restrictions might apply to exports from the EU with specific tariff codes: it will show where trade in some types of good under that category might be licensable or prohibited. Exporters must already provide tariff codes to the customs authorities (who use them to calculate the tax levied on the trade), so should be able to provide them to their banks, insurers and their agents. These can be used to identify transactions that might present higher risk or require further due diligence checks, particularly in situations where the risks are perceived to be higher). For example, have particular issuing banks, applicants or beneficiaries of letters of credit, or freight companies and shipping lines moving the goods, been highlighted by national authorities as being of concern? (This information will often be recorded on commercially available due diligence tools). Does the trade involve jurisdictions previously implicated in proliferation activity?

15.63 Techniques dependent on a firm's risk analysis/policy could range from random, after the event, monitoring to checking receivables in any form of securitisation transaction to seek to determine if they are legitimate.

15.64 Creating automated transaction monitoring rules for documentary trade transactions may be difficult due to the abundance of paper documents and the fact that neither the importer nor exporter may have a bank account with the relevant firm. Firms should thus ensure that documentary trade transactions are subject to trade-based due diligence checks by appropriately experienced staff to identify red flags and manage them accordingly.

15.65 For open account trading, the drivers of automatic monitoring of transactions that flag ‘unusual transactions’ tend to be built around:

- payment values
- volume of payments
- countries of payment
- originator/beneficiary names
- patterns in relation to a country or entity name
- volume of shipments (e.g., tonnes)

However, the exact configuration of monitoring systems will differ between firms.

15.66 Alerts generated from these automatic systems are usually subject to some type of human intervention. Therefore, the effective application of a risk-based approach to monitoring is only possible if based on intelligence-based risk indicators, such as geographical combinations or geographical patterns of high-risk payment flows.

15.67 Depending on the screening tool that it employs, a bank may be able to screen SWIFT messages for indications of prohibited or licensed goods, such as armaments.

15.68 The ability of a firm to detect suspicious activity will often be constrained. For instance, in the case of fragmented trade finance arrangements the availability of information will be a particularly limiting factor in enabling firm to understand who the ultimate buyer (or seller) of a product is, or what the ultimate end use of product may be. Whilst all firms are expected to have a form of financial transaction monitoring in place, the information presented to a firm will clearly vary according to its role in a particular transaction and the type of payment system used. For instance, in the case of letters of credit, the firm will have some information on the underlying transaction if it is the issuing bank but more limited information if it is the advising bank. The extent to which available information will need to be verified will also vary depending on this role.

Risk Mitigaton: Staff awareness, training and alertness

15.66 The firm must train staff on how trade finance transactions may be used for ML/TF and the firm's procedures for managing this risk. This training should be directed specifically at those staff directly involved in trade finance transactions, including those in relevant back office functions, and should be tailored around the specific risks that this type of business represents.

15.67 Trade Finance staff need to have an understanding of export licence regimes and of the importance of seeking evidence from relevant parties to the transaction that an export licence has been obtained where appropriate..

15.68 The red flag risk factors set out in Annex 15-IV, should be a useful aid to those devising firms' training programmes.

ANNEX 15-I

Glossary of trade finance terms and definitions used in this guidance

Acceptances/Deferred Payment Undertakings. Where the drawee of a bill of exchange signs the bill with or without the word "accepted" on it, the drawee becomes the acceptor and is responsible for payment on maturity. Where banks become the acceptor these are known as "bankers' acceptances" and are sometimes used to effect payment for merchandise sold in import-export transactions. Avalisation that occurs in forfaiting and some other transactions is similar to acceptance but does not have legal standing under English law. Banks may also agree to pay documents presented under a documentary credit payable at a future date that does not include a bill of exchange. In such instances the bank incurs a deferred payment undertaking.

Advising. The act of conveying Documentary Credit, Guarantee or SBLC to the beneficiary.

Advising Bank. Is a Correspondent Bank or a Non-Customer Bank of the issuing bank, usually located in the beneficiary's country that authenticates and advised the DC, SBLC or Guarantee to the beneficiary in accordance with the relevant ICC Rules.

Bills for Collection (BC). Documents (including a Bill of Exchange or Draft) submitted through a bank for the collection of payment from the drawer, also known as a Documentary Collection. A typical documentary collection involves documents forwarded by an exporter's bank to an importer's bank to be released in accordance with accompanying instructions. These instructions could require release of documents against payment or acceptance of a bill of exchange. As with Documentary Credits, there are a number of possible variations and the term collection is also used in other contexts. Collections of the type described above are usually handled subject to the applicable ICC Uniform Rules for Collections.

Bills of Exchange. A signed written unconditional order by which one party (drawer or trade creditor) requires another party (drawee or trade debtor) to pay a specified sum to the drawer or a third party (payee or trade creditor) or order, on demand or at a fixed or determinable future time. In the UK, the relevant legislation is the Bills of Exchange Act 1882, as amended. In cross-border transactions, equivalent laws may also apply. In many other European jurisdictions, transactions will be subject to the Geneva Conventions on Bills of Exchange 1932. Bills of Exchange can be payable at sight or at a future date, and if either accepted and/or avalised, represent a commitment by the accepting or avalising party to pay funds, thus making them the primary obligor.

Collections. See Bill for Collection (BC).

Collecting Bank. The bank (in BCs) in the drawee's (buyer's) country that is instructed to collect payment from the drawee.

Confirm or Confirming. Act of a bank, other than the issuing bank, assuming the liability for payment, acceptance or negotiation of conforming documents submitted by the beneficiary.

Confirming Bank. The bank acting on the nomination of the issuing bank to act as the paying, accepting or negotiating bank and paying on the due date against the conforming documents submitted by the beneficiary.

Discounting. Act of purchasing or prepaying an accepted bill of exchange or documents presented under Documentary Credit.

Documentary Credits (DC). Is a written undertaking by a bank (issuing bank) given to the seller (beneficiary) at the request of the buyer (applicant) to pay a stated sum of money against presentation

of documents complying with the terms of the credit within a set time limit. There are three types of commercial DC: Sight DCs, Acceptance DCs and Deferred Payment DCs (the latter two are often referred to as Usance DCs whereby payment is to be made at a date determined by the terms of the credit, e.g. 120 days after Bill of Lading date). A Deferred Payment DC is similar to an Acceptance DC except no Bills of Exchange or drafts are presented or accepted. The issuing bank is responsible to make payment on due date.

Forfaiting. This is a financing mechanism traditionally designed for use by trade creditors who export goods. Forfaiting, however, may also involve the direct provision of finance to importers and the provision of working capital by credit institutions for the purposes of funding trade transactions in their countries. The trade creditor or exporter sells evidence of a debt, usually a promissory note issued by the importer or a bill of exchange accepted by the importer or proceeds due under a Letter of Credit such proceeds being assigned by the exporter. The sale is normally made without recourse to the trade creditor/exporter in which case the person buying the debt will usually require the importer's payment obligations to be guaranteed by a bank (avalised).

Guarantees and Indemnities. Sometimes called Bonds, these are issued when a contractual agreement between a buyer and a seller requires some form of financial security in the event that the seller fails to perform under the contract terms, and are normally issued against a backing "Counter Indemnity" in favour of the issuing firm. There are many variations, but a common theme is that these are default instruments which are only triggered in the event of failure to perform under the underlying commercial contract.

Negotiation. This term has a variety of meanings dependent on the jurisdiction/territory in which it is being used but for the purposes of UCP 600 means "the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/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".

Presenting Bank. For DC, SBLC and Guarantees, it is the bank that presents drafts and/or documents or a claim for payment. For BCs, it is the collecting bank that makes presentation to the drawee.

Promissory Notes. These are a written promise committing the issuer to pay the payee or to order, (often a trade creditor) a specified sum either on demand or on a specified date in the future. (This is similar to a bill of exchange).

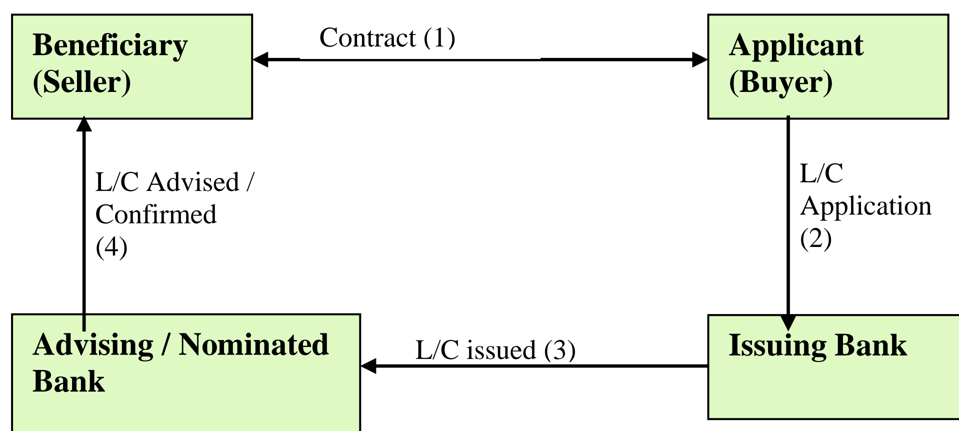
Remitting Bank. A term used in BCs that means the bank to which the principal has entrusted the handling of a collection.

Standby Letters of Credit. Unlike Documentary Credits, Standby Letters of Credit are default instruments which are sometimes issued instead of a guarantee. They are usually subject to the applicable ICC rules in force, currently either UCP 600 or International Standby Practices (ISP 98).

ANNEX 15-II

The Process for a Confirmed Documentary Credit payable at sight at the counters of the nominated bank

Stage 1



Basic Documentary Credit Procedure

The documentary credit procedure involves the step-by-step exchange of documents required by the credit[19] for either cash or a contracted promise to pay at a later time. There are four steps in the procedure: (a) Issuance; (b) Amendment, if any; (c) Utilisation; and (d) Settlement. A simplified example follows:

(a) Issuance

Issuance describes the process of the buyer applying for and the issuing bank issuing a documentary credit in favour of a beneficiary.

(1) Contract – The Buyer and Seller agree on the terms of sale: (a) specifying a documentary credit as the means of payment, (b) specifying the relevant terms and conditions, and (c) listing required documents. A specific advising bank may be requested by the buyer or may be chosen by the issuing bank based on its correspondent network.

(2) Issue Credit – The Applicant applies to his bank (Issuing Bank) and the issuing bank opens a documentary credit naming the Seller as beneficiary based on specific terms and conditions listed in the credit.

(3) Documentary Credit – The Issuing Bank forwards the documentary credit to the beneficiary either directly or through an advising bank. An advising bank may also act as a nominated bank which is authorized to honour (pay at sign, accept a bill of exchange or incur a deferred payment obligation) or negotiate (nominated bank) under the credit or act as a confirming bank where it adds its undertaking to the credit. The nominated bank may also be requested to add its confiscation to the credit, in addition to that of the issuing bank. Only in those cases where an advising bank is not nominated to negotiate or confirm the credit is the role of that bank simply an advising bank.

(4) Advise of Documentary Credit - The advising bank advises the documentary credit to the beneficiary.

(b) Amendment

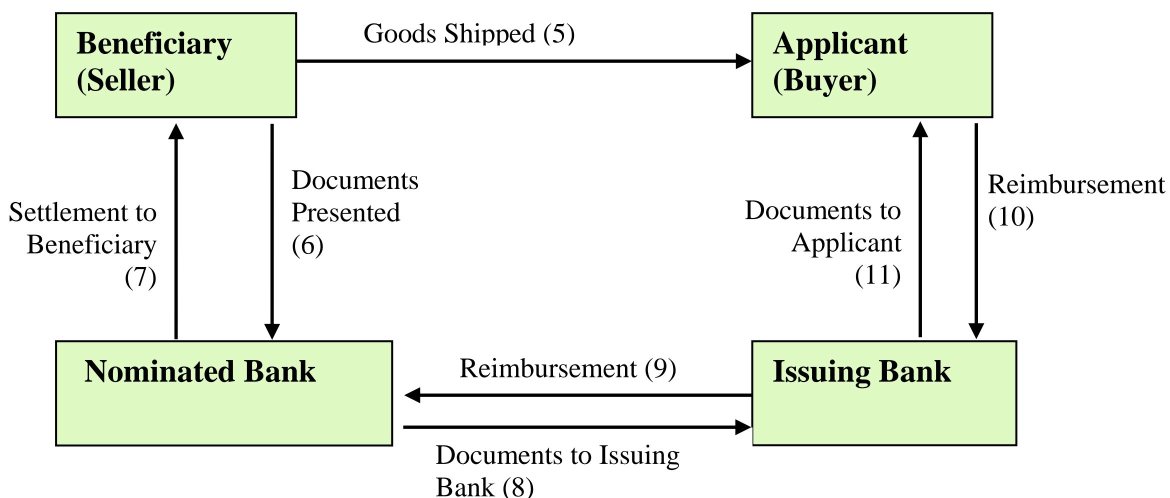
Amendment describes the process whereby the terms and conditions of a documentary credit may be modified after the credit has been issued.

When the beneficiary receives the documentary credit, it may disagree with the terms and conditions (e.g. the transaction price listed in the credit may be lower than the originally agreed upon price) or may be unable to meet specific requirements of the credit (e.g. the validity of the credit may be too short to effect shipment).

If the beneficiary wants to amend the terms prior to transacting, they should request these from the buyer. It is at the discretion of the buyer to agree to the proposed amendments and request an amendment to be issued by the issuing bank. An amended letter of credit would be issued by the issuing bank and routed through the same channel as the original documentary letter of credit.

Amendments to a letter of credit require the agreement of the issuing bank, confirming bank (if any), and the beneficiary to become effective.

Stage 2



(c) Utilisation

Utilisation describes the procedure for the transfer of documents from the seller to the buyer through the banks (presentation), and the transfer of funds from the buyer to the seller through the banks (settlement). For example:

(5) Seller ships goods – The seller (beneficiary) ships the goods to the buyer and obtains the documents required under the letter of credit.

(6) Seller presents documents to Nominated Bank or directly to the Issuing Bank – The seller prepares and presents the required documents to the nominated/confirming bank consisting of (a) the transport document if required by the credit, and (b) other documents (e.g. commercial invoice, insurance document, certificate of origin, inspection certificate, etc.) as required by the documentary credit.

(7) Nominated Bank reviews documents - The nominating bank (a) reviews the documents to ascertain that they are in conformity with the terms of the credit and (b) if it has added its confirmation pays the seller (it will honour or negotiate the documents based upon the terms of the credit). An advising bank

that is not a nominated bank does not normally examine the documents, but simply forwards them on to the confirming or issuing bank for their examination in accordance with the terms of the credit.

(8) Nominated Bank transfers documents to Issuing Bank – The Nominated bank sends the documentation by mail or courier to the issuing bank in accordance with the terms of credit.

(9) Issuing Bank reviews documents and reimburses the Nominated Bank or makes payment to the beneficiary through the presenting bank – The Issuing Bank (a) reviews the documents to ascertain that the documents are in conformity with the terms of the credit and (b) reimburses the nominated bank or presenting party (based upon the terms of the credit),

(10) Applicant reimburses the Issuing Bank – The Buyer reimburses the amount paid by the issuing bank in accordance with the facility terms between them.

(11) Buyer receives documents and access to goods – The Issuing Bank delivers the documents to the buyer who then takes possession of the shipment.

(d) Settlement

The form of payment is specified in the original credit. The following are common settlement methods:

- Sight Credit (Settlement by Payment) – In a sight credit, the value of the credit is available to the exporter as soon as the terms and conditions of the credit have been met (as soon as the prescribed document package has been presented to and checked by the issuing or nominated bank and found to be conforming to the terms and conditions of the credit) or once the nominated bank has received the funds from the issuing bank (unconfirmed). Payment may be affected (sic) directly by the nominated bank upon their examination of the documents and they are reimbursed for that payment by the issuing bank. If the nominated bank also adds its confirmation to the credit, it must honour or negotiate a complying presentation.

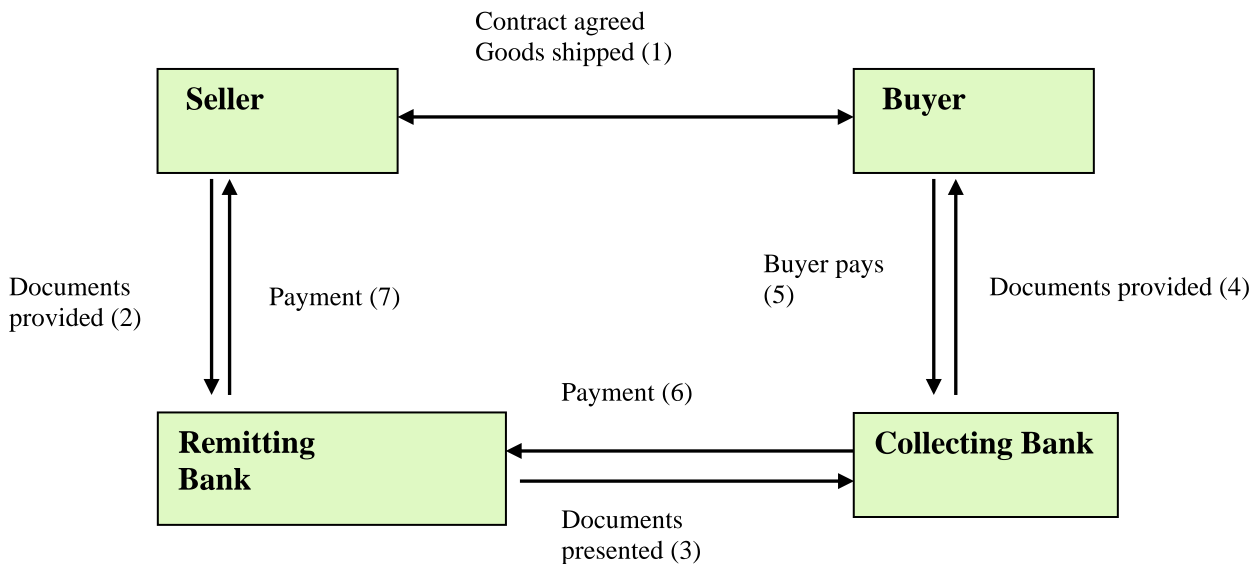
- Acceptance Credit – In an Acceptance Credit, the beneficiary presents the required documents to the nominated bank along with a draft (Bill of Exchange) drawn on the issuing or nominated bank, for the value of the credit. Once the documents have been found to be in order, the draft is accepted by the bank upon which it is drawn (the draft is now called an acceptance) and it may be returned to the seller for representation on maturity.

- Deferred Payment Credit - In a deferred payment credit the issuing bank and/or the nominated bank accepts the documents and pays the beneficiary after a set period of time. The issuing or nominated bank makes the payment at the specified time, when the terms and conditions of the credit have been met.

- Negotiation is the term used where a bank other than the issuing bank agrees to advance funds or discount drafts and/or documents to the seller before the issuing bank has paid. Discounting an accepted draft has a similar effect.

Note: Acceptance and Deferred payments are both types of Usance meaning payment at a determinable future date.

The Documentary Collection Process



The documentary collection procedure involves the step-by-step exchange of documents for either payment or an undertaking from the buyer to pay at a later time.

Contract for the purchase and sale of goods – The Buyer and Seller agree on the terms of sale of goods: (a) specifying a documentary collection as the means of payment, (b) naming a Collecting Bank (usually the buyer's bank), and (c) listing required documents.

(1) Seller ships the goods – The Seller ships the goods to the Buyer and prepares the required documents to be delivered to the Remitting Bank.

(2) Seller presents documents to Remitting Bank – The Seller prepares and presents documents to their bank (the Remitting Bank) consisting of: (a) a collection order specifying the terms and conditions under which the Collecting Bank is to hand over documents to the Buyer and receive payment, and (b) the documents (e.g. transport document, insurance document, certificate of origin, inspection certificate, etc.) as required by the buyer in accordance with the contract.

(3) Remitting Bank sends documents to Collecting Bank – The Remitting Bank sends the documentation package to the Collecting Bank in the Buyer's country with instructions to present them to the Buyer and obtain settlement.

(4) The Collecting Bank reviews and provides documents to Buyer – The Collecting Bank (a) reviews the documents making sure they appear to be as listed in the collection order, (b) notifies the Buyer about the terms and conditions of the collection schedule, and (c) releases the documents once the payment or acceptance conditions have been met. Acceptances under documentary collections are known as "Trade Acceptances" which, when accepted (by the Buyer), only carry the obligation of the buyer as opposed to a "Bankers' Acceptance' commonly used under a letter of credit which carries the obligation of a bank.

(5) Buyer provides settlement to Collecting Bank – The Buyer (a) makes payment, or if the collection schedule allows, signs an acceptance (promise of the Buyer to pay at a future date) and (b) receives the documents and takes possession of the shipment.

(6) Collecting Bank provides payment to Remitting Bank – Upon receipt of payment from the buyer, the Collecting Bank pays the Remitting Bank either at sight or, at the maturity date of the accepted bill of exchange, when it receives payment from the Buyer.

(7) The Remitting Bank pays the Seller.

ANNEX 15-III (Paragraph 15.20)

WITTING AND UNWITTING ACTORS

[EXTRACT FROM FATF FEBRUARY 2010 WORKING GROUP REPORT]

Proliferators abuse typical trade structures to facilitate their activities, which include supporters, financiers, logistical support, front companies, assets, shippers and facilitators. Entities that are knowingly engaged in proliferation, such as a front company, may also be involved in legitimate business. Other actors used by a network may knowingly support proliferation, be "wilfully blind" that they are being used for illicit purposes, or are truly unwitting actors. When an entity is engaged in both legitimate and illicit trade it may be less likely for financial institutions to suspect illegal activity.

Front and Other Companies

In individual cases, proliferation networks have employed companies to conceal the true end-use or end-user of traded goods. Most front companies are sensitive to public exposure and disruption of legitimate activities.

Front companies established by proliferators conduct transactions similar to those of companies engaged in legitimate business. Front companies used by proliferators may be similar to those established by money launderers. As is the practice of other criminal organisations, proliferators create companies for a seemingly legitimate commercial purpose and commingle illegal funds with funds generated by legal commercial activity. In some cases, front companies established by proliferators do not engage in any legal activity at all. Front companies may use fraudulent accounting practices and establish various offshore entities in jurisdictions with lax controls to disguise illegal operations. Proliferators are also known to change the names of front companies, or to use multiple names for the same front company, to prevent the detection of the companies' association with proliferation – or other illicit activity.

Front companies used by proliferators are often located in a major trading hub of a foreign jurisdiction with lax export controls, but may also be found in jurisdictions with more established controls. They can be shell corporations with a fictitious business and physical location or can have normal commercial and industrial operations.

Front companies can arrange shipping services, routing or re-routing goods acquired by the importer or its intermediary. The same and/or additional companies can also be located in jurisdictions with weak financial controls, enabling related financial transactions to settle the underlying trade without detection.

In exceptional cases, front companies may seek complicity within a particular jurisdiction's government for sign off by national authorities, by production of false cargo manifests to misdirect customs, law enforcement, and intelligence as to the true nature of the goods being exported and their end-use.

Brokers

Brokers are involved in the negotiation or arrangement of transactions that may involve the transfer of items (often between third countries) or who buy, sell or arrange the transfer of such items that are in their ownership. In addition, they may also become involved in ancillary activities that facilitate the movement of items such as, but not limited to: *i)* providing insurance; *ii)* marketing; *iii)* financing; and *iv)* transportation / logistics. Illicit brokers illegally participate in proliferation by circumventing existing controls and obfuscating trade activities.

Brokers used by proliferation networks are often individuals relying on simple commercial structures, who are very mobile (financially and geographically) so that they can operate from any jurisdiction.

Other Intermediaries

Intermediaries may include companies and individuals that purchase or sell sensitive goods for further manufacture or redistribution. Intermediaries may have a particular knowledge of a jurisdiction's commercial infrastructure. Intermediaries that are knowingly engaged in proliferation will use this knowledge to exploit vulnerabilities in export control systems to the advantage of the proliferator.

Financial Institutions

Proliferation networks may use financial institutions to hold and transfer funds, settle trade and pay for services. Proliferation networks may use both private and public financial institutions for international transactions. States seeking to acquire WMDs may also use foreign branches and subsidiaries of state-owned banks for proliferation finance-related activities, giving these institutions the responsibility of managing funds and making and receiving payments associated with proliferation-related procurement or other transactions. These subsidiaries may be engaged in both legitimate and illegitimate transactions.

ANNEX 15-IV

A non-exhaustive list of illustrative red flag risk factors which may be identifiable during the normal course of business may include, but are not limited to:

A. Customer-related

- The customer wishes to engage in transactions that lack business sense or apparent investment strategy, or are inconsistent with the customer's stated business strategy (e.g. a steel company that starts dealing in paper products, or an information technology company that starts dealing in bulk pharmaceuticals);
- A customer significantly deviates from their historical pattern of trade activity (i.e. in terms of value, frequency or merchandise);
- Transacting businesses share the same address, provide only a registered agent's address, or have other address inconsistencies;
- Pre-accepted discrepancy(ies) by the applicant and/or the applicant is over-keen to waive discrepancy(ies);
- Excessive/aggressive/pressured contact by the client;
- Customer is reluctant to provide clear answers to routine financial, commercial, technical or other questions;
- Use of LCs to move money between those countries, where such trade would not normally occur and / or is not consistent with the customer's usual business activity. An LC is often used to bring more legitimacy to the transaction in order to conceal the real facts.
- A sole individual or small number of closely connected individuals (a family for example) exert majority beneficial ownership/ significant control over the customer. Such beneficial owners' may potentially have the over-arching ability to bypass certain checks and controls and/or over-ride internal governance to process transactions.

B. Document-related

- Shipment locations of the goods, shipping terms, or descriptions of the goods are inconsistent with the supporting trade documentation. This may include changes in shipment locations to high-risk countries or changes in the quality of the goods shipped;
- Where the firm becomes aware of significant discrepancies which appear between the descriptions of the goods on the bill of lading (or invoice) and the actual goods shipped;
- Applicant-issued documents called for in the letter of credit;
- Unauthorised alterations/amendments to documents;

- Beneficiary or applicant refuses to provide documents to prove shipment of goods (possible phantom shipping or multiple invoicing);

- Bill of lading consigned: 'to be advised between applicant and beneficiary'. Consignment should be to a named party (usually the Applicant, Broker, Bank or to the order of shipper blank endorsed);

- Bill of lading describing containerised cargo, but without container numbers or with sequential numbers, non-standard numbers or indicates IRISL (Iran) prefix;

- Unusual codes, markings or stamps appear on monetary instruments, such as drafts or bills of exchange;

- Re-presentation of an official document immediately after it has been refused for a discrepancy;

- Re-presentation of any shipping documents that were rejected for reasons related to international sanctions compliance. This re-presentation could indicate the *'stripping'* of relevant information for the purposes of circumventing international sanctions regimes.

- Obvious alterations to third-party documents, e.g. bills of lading, customs forms;

- Future dated bills of lading;

- LC received on an unauthenticated basis;

- The identification of a potential dual-use good.

C. Transaction-related

- Transaction is between or involves related parties;

- Transaction structure appears unnecessarily complex and designed to obscure the true nature of the transaction;

- The transaction is an offshore shipment (e.g. buyer/seller located in UK, while movement of goods occurred offshore of UK);

- Transaction involves an unusual intermediary or number of intermediaries;

- 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 review from a sanctions perspective;

- In the case of Letters of Credit, the LC contains non-standard clauses, or phrases such as:
  - request to issue a 'ready, willing and able' message, or a 'letter of interest'
  - LC is 'unconditional, divisible and assignable'
  - transactions requiring 'proof of product'
  - funds are 'good, clean and cleared, of non-criminal origin'
  - bearer instrument letter of credit, or

- transferable and assignable without being used.

- A party to a transaction is a shell company;

- Approach from previously unknown party, which is hard to or cannot be verified, who appears evasive of their identity or connections or whose references are unconvincing;

- Same address used for different transacting parties, usage of registered agent's address, or other address inconsistencies;

- Unexplained or unnecessary parties to the transaction and who appear evasive about their identity/role on further enquiries;

- Transaction involves the receipt of cash (or other payments) from third party entities that have no apparent connection with the transaction;

- Payment or payment requests for proceeds to a third party unrelated to the customer;

- Unusual deposits i.e. use of cash or negotiable instruments (such as traveller's cheques, cashier's cheques and money orders) in round denominations (to keep below reporting threshold limit) to fund bank accounts and to pay for goods and services. The negotiable instruments may be sequentially numbered or purchased at multiple locations and may frequently lack payee information. Further, cash payments for high-value orders are also indication of TBML activity;

- Trade transaction reveals links between representatives of companies exchanging goods i.e. same owners or management. TBML requires collusion between traders at both ends of the import/export chain. Related party transactions (ie transactions between entities that are part of the same corporate or business group) can possibly make TBML easier and more difficult to detect. Related party transactions, including transfer pricing, rely on mutual agreements between the parties, rather than free market forces. Although there is a higher risk of related party transactions being used for fraud and for TBML, dealings between related parties are not necessarily illegal;

- Transfer pricing is a related party transaction that is commonly used by transnational corporation as part of their financial and tax planning strategy. Multinational organisations use transfer pricing to shift taxable income from jurisdictions with relatively high tax rates to jurisdictions with relatively low tax rates to minimise income tax. Similar strategies are also employed in relation to import duties and value added tax.

- Blending various types of crude originating from high-risk jurisdictions without certificates of origin might be an indication of an attempt to disguise the origin of the crude;

- Where there is an applicant bank and where the ordering party is not the applicant but is an unrelated third party.

- The transaction involves a 'switch bill of lading', which is a second set of bill of lading issued by the carrier (or its agent) to substitute the original bills of lading issued at the time of shipment.

D. Payment-related

- Unexplained changes to payment instructions;
- Request to pay an unrelated third party;
- Payment is to be made to beneficiary's account held in another country other than the beneficiary's stated location;
- Unusually favourable payment terms, such as payment substantially far above or below expected market price, interest rate substantially far above or below known prevailing rate, or lump-sum cash payment;
- The transaction involves an unusual trigger point for payment (e.g. before goods are shipped, with no documentation required);
- Changing the LC beneficiary or BC payee name and address just before payment is to be made. Including requests for assignment of proceeds or transfer at the time documents are presented;
- LC or BC purportedly covers the movement of goods but fails to call for presentation of transport documents. For example, an LC covers steel shipment but allows a forwarder's cargo receipt (FCR);
- The method of payment appears inconsistent with the risk characteristics of the transaction. For example, the use of an advance payment for a shipment from a new supplier in a high-risk country;
- The transaction involves the receipt of cash (or other payments) from third party entities that have no apparent connection with the transaction.
- The transaction involves the use of repeatedly amended or frequently extended letters of credit.

E. Shipment-related

- Trade transactions where the quantity of goods exceeds the known capacity of the shipping containers or the tanker capacity. Or where abnormal weights for goods are suspected;
- The shipment does not make economic sense. For example, the use of a forty-foot container to transport a small amount of relatively low-value goods;
- Shipping documents show weights and measures inconsistent with the goods shipped or method of shipment;
- Significant discrepancies appear between the description of the commodity on the bill of lading and the invoice;
- Significant discrepancies appear between the description of the goods on the bill of lading (or invoice) and the actual goods shipped;

- Significant discrepancies appear between the value of the commodity reported on the invoice and the commodity's fair market value;

- The size of the shipment appears inconsistent with the scale of the exporter's or importer's regular business activities;

- The type of commodity being shipped is designated as potentially "higher risk" for money laundering or terrorist financing, including those difficult to value;

- The type of commodity being shipped appears inconsistent with the exporter's or importer's regular business activities;

- The commodity is shipped to (or from) a jurisdiction designated as "high risk" for money laundering activities;

- The commodity is transhipped through one or more jurisdictions for no apparent economic reason;

- In the case of merchanting trade, the trade finance mechanism should be in place for both export leg as well as import leg of transaction. If the Trade Finance mechanism, for example, Letters of Credit, have been provided for only the import leg of the transaction and not for export leg, it also indicates the possibility of TBML;

- Presence of Free Trade Zones / Special Economic Zones also affects the sensitiveness of a jurisdiction as far as TBML is concerned. FTZs are also emerging as being especially vulnerable to TBML. FATF defines FTZs as 'designated areas within countries that offer a free trade environment with a minimum level of regulation'. In the said report, FATF noted that most zone authorities operate separate company formation services from those that exist in the rest of the jurisdiction and market the ease of setting up a legal entity in an FTZ to attract business. Many zone authorities request little or no ownership information of the companies interested in setting up in the zone. As a result, it is simpler for legal entities to set up the firms/companies in FTZs and hide the name(s) of the true beneficial owners. This lack of transparency has allowed companies located in FTZs to create layers of transactions that are difficult (if not impossible) for law enforcement agencies to follow (FATF 2010). It also reported that 'goods introduced in an FTZ' are generally not subject to the usual customs controls, with goods undergoing 'various economic operations, such as transhipment, assembly, manufacturing, processing, warehousing'. FinCEN has identified TBML red flags that are specific to FTZs. In its 2010 report, FinCEN (2010: 4) signalled that a number of red flags seen in conjunction with shipments of high dollar merchandise (such as electronics, auto parts and precious metals and gems) to duty free trade zones could be an indication of a trade-based ML activity. These include:
    - third-party payments for goods or services made by an intermediary (either an individual or an entity) apparently unrelated to the seller or purchaser of goods. This may be done to obscure the true origin of the funds;
    - amended letters of credit without reasonable justification;
    - a customer's inability to produce appropriate documentation (i.e. invoices) to support a requested transaction; and
    - significant discrepancies between the descriptions of the goods on the transport document (i.e. bill of lading), the invoice, or other documents (i.e. certificate of origin, packing list etc.) (FinCEN 2010).

- Circuitous route of shipment and/or circuitous route of financial transaction or Order for the goods is placed by firms or individuals from foreign countries other than the jurisdiction of the

stated end-user;

- Discharging and loading at remote ports without an apparent commercial rationale.

- A vessels AIS (Automatic Identification System) goes dark/ switched off in waters within close proximity to high risk/ sanctioned jurisdictions[10].

- A Ship-to-Ship (STS) transfer has been conducted – there are some legitimate uses however the true origin and nature of the cargo can be concealed through this process.

[10] With regards to the AIS and STS for further background see OFSI Maritime Guidance: Financial sanctions guidance for entities and individuals operating within the maritime shipping sector: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/903901/OFSI_-_Maritime_guidance__July_2020_.pdf

ANNEX 15-V

Proliferation financing - Risk assessment of customers and products

1. The purpose of a risk-based approach is not the elimination of risk but rather that firms involved in high-risk activity understand the risks they face and have the appropriate policies, procedures and processes in place to manage such risk. Equally, even reasonably applied controls will not identify and detect all instances of proliferation.

2. It would be impractical for firms to be expected to develop a dedicated risk-assessment framework for assessing proliferation financing risks alone. It would be more proportionate to include proliferation considerations alongside the wider determination of risks factors. Moreover, established mechanisms to conduct risk assessment and to identify suspicious activity of wider criminal activity are, in many cases, likely to be applicable to proliferation considerations.

3. The application of a risk-based approach to proliferation financing has both similarities to, and differences from, money laundering. They both require a process for identifying and assessing risk, but the characteristics of proliferation financing – including the limited availability of accessible information to determine risk – result in a more restricted scope for the application of risk-based measures. In acknowledgement of such limitations this guidance seeks to identify potential areas where risk-based decisions could be applied in the area of proliferation financing.

4. Clearly, in some circumstances a risk-based approach will not apply, will be limited, or will be determined by the parameters set by international obligations, national law or regulation. Where particular individuals, organisations or countries are subject to proliferation sanctions, the obligations on firms to comply with certain actions are determined exclusively by national authorities and are therefore not a function of risk. A risk-based approach may, however, be appropriate for the purpose of identifying evasion of sanctions, for example, by directing resources to those areas identified as higher risk.

5. The inclusion of proliferation financing within current risk assessment practices should be proportionate to the overall proliferation risk associated with the activities undertaken by the firm. For example, a firm operating internationally and/or with an international client base will generally be expected to assess a wider range of risks, including proliferation, than a smaller, domestically-focused one.

6. In the application of a risk-based approach, measures and controls implemented by firms may often address more than one identified risk, and it is not necessary that a firm introduce specific controls for each risk. For instance, risks associated with proliferation financing are likely to sit alongside other country, customer and product risks. Additional information that may be useful could include further information on the parties to a transaction, source of funds, beneficial ownership of the counterparty and purpose of the transactions or payment.

Country/geographic risk

7. The most immediate indicator in determining risk will be whether a country is subject to a relevant UN sanction; in these instances some element of mandatory legal obligation will be present, along with risks related to sanctions evasion by sanctioned entities, and proliferation financing by unsanctioned entities. Depending on the extent of risk assessment and business conducted, other factors that may be considered could include:

    - Countries with weak or non-existent export controls (the FATF Proliferation Financing report noted that only 80 jurisdictions have any exports controls related to WMD). Individual country compliance with export control obligations are not, however, currently published. In

the absence of such information, firms will not be in a position to make an informed assessment and therefore will not be in a position to utilise this indicator. If, however, such information became forthcoming – either at an international or individual government level – it could provide an additional factor that could potentially inform country risk assessment.

Customer risk

8. Any assessment of the risks that a customer may pose will be underpinned by customer take-on procedures and developed further by ongoing monitoring. Specific categories of customer whose activities may indicate a higher proliferation financing risk could include:

   - Those on national lists concerning high-risk entities.

   - Whether the customer is a military or research body connected with a high-risk jurisdiction of proliferation concern.

   - Whether the customer is involved in the supply, purchase or sale of dual-use and sensitive goods. Firms rely on export control regimes and customs authorities to police the activities of exporters who are their customers. Among others, export control authorities and customs authorities ensure that licensing requirements for dual-use goods have been met. Therefore, the fact that a customer is involved in the supply, purchase or sale of dual-use goods is, of itself, not an indicator for a firm; this would result in a disproportionately large number of trading companies falling into this category. However, a wide range of industrial items and materials can assist WMD programmes and would-be proliferators. The most critical items normally appear on national strategic export control lists, although screening against controlled goods lists is not a practical solution for firms. The involvement in the supply, purchase or sale of dual-use goods may therefore be of some relevance if other risk factors have first been identified.

9. Mitigating factors should also be considered, for example whether the customer is itself aware of proliferation risks and has systems and processes to ensure its compliance with export control obligations.

Transactions risk

10. In determining whether the transaction presents an elevated risk, a number of factors should be considered:

    - Specific nature of the underlying transaction and whether it contains a valid and apparent commercial rationale
    - Terms of the underlying agreement
    - Relationship nature between the FI, client and any potential 3rd party
    - A number of participants involved and consideration of potential fragmentation and complexity
    - Involvement of manual processing/screening of various paper instruments
    - Whether a transaction is conducted on an open account or credit instrument basis

Delivery channels risk

11. Customer relationship commenced without a face to face meeting may present a higher financial crime risk than a relationship commenced following a customer meeting. The risks could include:

- Whether the customer legally exists i.e. shell or front company
- Whether they operate from the stated location
- Whether the nature of the business activity is as stated
- Whether the size of the customer is as stated
- Whether the representatives are the persons who own or control the customer
- Any other information provided by the customer does not match information which could be obtained by a physical meeting at the place of business

<u>Product and Service Risks</u>

12. Determining the risk of products and services may include a consideration of factors such as:

    - Delivery of services to certain entities Project financing of sensitive industries in high-risk jurisdictions.
    - Trade finance services and transactions involving high-risk jurisdictions.

13. As is the case with anti-money laundering, any assessment of risk will need to take account of a number of variables specific to a particular customer or transaction. This will include duration of relationship, purpose of relationship and overall transparency of relationship and/or corporate structure. It would be disproportionate to assess a stable, known customer who has been identified as involved in the supply, purchase or sale of dual-use and sensitive goods as either moderate or high-risk for that reason alone. However, the overall assessment of risk may increase with the presence of other factors i.e., delivering high volumes of dual-use or sensitive goods to a high-risk country/complicated corporate structures/the type and nature of principal parties engaged in the transaction. Consideration of these risks, including customer-specific information, and mitigating factors, will enable a firm to reach a graduated understanding of the degree of proliferation finance risk a particular customer poses.

14. Interpretation of "dual-use" requires a degree of technical knowledge that letter of credit document checkers cannot be expected to possess. In addition, the description of the goods may appear in the documents using a wording which does not allow the identification of such goods as "dual-use". Regardless of the details in the information sources, however, without the necessary technical qualifications and knowledge across a wide range of products and goods, the ability of a firm to understand the varying applications of dual-use goods will be virtually impossible. It would be impracticable for firms to employ departments of specialists for this purpose.

15. Firms may nevertheless refer to sources of information that may be relevant to assessing the risk that particular goods may be 'dual-use', or otherwise subject to restrictions on their movement. For example, there are public resources (such as the EC's TARIC database) that can indicate which restrictions might apply to exports from the EU with specific tariff codes: it will show where trade in some types of good under that category might be licensable or prohibited. Exporters must already provide tariff codes to the customs authorities (who use them to calculate the tax levied on the trade), so should be able to provide them to their banks, insurers and their agents. These can be used to identify transactions that might present higher risk or require further due diligence checks, particularly in situations where the risks are perceived to be higher). For example, have issuing banks, applicants or beneficiaries of letters of credit, or freight companies and shipping lines moving the goods, been highlighted by national authorities as being of concern? (This information will often be recorded on commercially available due diligence tools). Does the trade involve jurisdictions previously implicated in proliferation activity?

16. UK exporters seeking to send goods to countries subject to trade restrictions may also be in contact with the Export Control Joint Unit (ECJU) of the Department for International Trade to clarify

whether their shipments will be affected. A firm financing trade with such countries may inquire whether such correspondence has been entered into, particularly if it appears that the goods in question may require an export licence.

17. The ECJU provides additional guidance at [https://www.gov.uk/guidance/exporting-controlled-goods-after-eu-exit.](https://www.gov.uk/guidance/exporting-controlled-goods-after-eu-exit)