UNINOVA
BANK

WOLFBERG PRINCIPLES ON TRADE & FINANCE

phone: + +269 3 616 370 | whatsapp: +44 7458 164686 | 624, Hamchako, Anjouan, Union of Comoros |
www.uninovabank.com
info@uninovabank.com

WOLFBERG PRINCIPLES ON TRADE & FINANCE

1. Preable

These principles form part of broad based and on going industry efforts to define standards for the control of AML risks associated with trade finance activities.

2. Background

- To address the risks of money laundering and terrorist financing (collectively referred to as AML) through certain trade finance products. Whilst this paper addresses the risks of both money laundering and terrorist financing, it should be noted that what FIs can do with respect to the latter is limited. See Section 4(c) of this paper.
- To aid compliance with international and national sanctions, including the Non Proliferation of Weapons of Mass Destruction (NPWMD) requirements of the United Nations (UN).

Trade finance can, in its broadest interpretation, be described as being the finance by FIs of the movement of goods and services between two points, both within a country's boundaries as well as cross border. Trade finance therefore encompasses both domestic as well as international commerce. Trade Finance activities comprise a mix of money transmission conduits, default undertakings, performance undertakings and the provision of credit facilities. All FIs involved in the finance of trade should have adopted risk policies and controls which are appropriate for their business.

Historically trade finance has not been viewed as a high risk area in relation to money laundering. This perception has changed of late and increasingly regulators and international bodies view trade finance as a "higher risk" area of business for money laundering, terrorist financing and, more recently, for transactions related to the potential breach of international and national sanctions, including the proliferation of WMD. The Wolfsberg Group is committed to the application of appropriate systems and controls in respect of trade finance products to mitigate these risks. It does not however believe that currently there is sufficient evidence to support an assessment of this area as high risk for AML/Sanctions purposes.

It should be recognised however that the majority of world trade (approximately 80%) is now carried out under "Open Account" terms. This means that the buyer and seller agree the terms of the contract, the goods are delivered to the buyer who then arranges a clean payment, or a netting payment, through the banking system. In these circumstances, unless the FI is providing credit facilities, the FI will only see the clean payment and will not be aware of the underlying reason for the payment. The FI has no visibility of the transaction and therefore is not able to carry out anything other than the standard AML and Sanctions screening on the clean/netting

payment. Where the FI is providing credit in relation to the trade transaction there may be more opportunity to understand the underlying trade and financial movements. Further reference to open account can be found in Appendix IV.

This paper will address (through appendices) the mechanisms used for the finance of the movement of goods or services across international boundaries. The standard products are Documentary Letters of Credit (LCs) and Documentary Bills for Collection (BCs). Although LCs and BCs can also be used domestically, this remains prevalent only in non OECD countries. These standard products have trade related documents (invoices, transport documents etc.) that are sent through FIs and are examined by the FI for consistency with the terms of the trade transaction. Both these products are governed internationally by sets of rules of practice issued under the auspices of the International Chamber of Commerce (ICC) in Paris (*see footnote3). These Rules, and the standard international banking practice they have created, affect the ways that FIs can follow AML, Sanctions and NPWMD requirements.

It is important to recognise the important and respective roles of the ICC and FIs in promoting international commerce and free trade by supporting the timely and efficient movements of goods, documents and payments. Applying additional or more onerous requirements to importers and exporters in relation to these products may in fact be counterproductive and provide additional incentive to avoid these products, which may lead to an increase in “open account” transactions and therefore to less transparency.

This paper will also address Standby Letters of Credit (SBLCs) and Guarantees (Gtees) because they can be used in relation to trade finance.

The paper will not address other products/services associated with the financing of trade such as vendor financing or structured trade finance involving the use of export credit agency services, insurance or forfait transactions. It is however anticipated that further guidance will be given in relation to these products/services by appropriate additions to appendices as appropriate. Furthermore it is not proposed to cover the management of other risks that may be present, in particular fraud.

3. The Role of Financial Institutions

One of the basic tenets of trade finance, codified in international standard banking practice through the ICC sets of rules, is that “Banks deal with documents and not with goods, services or performance to which the documents may relate”. Banks do not get involved with the physical goods nor do they have the capability to do so. This overarching principle is the basis for defining what degree of scrutiny and understanding a FI can bring to the identification of unusual activity involving a trade finance transaction.

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

4. Money Laundering/Terrorist Financing

(a) Risks

Despite the fact that historically trade finance has not been viewed as high risk it has been recognised that international trade and the processes and systems that support it are vulnerable to abuse for the purposes of money laundering and terrorist financing. In recent years, however, the focus on these risks has increased for a variety of reasons, including the dramatic growth in world trade. In addition, the fact that controls introduced by FIs in response to the more traditional money laundering techniques have become more robust means that other methods to transmit funds, including the use of trade finance products, may become more attractive to criminals. FATF have identified these risks in the widely defined area of Trade Based Money Laundering4. It is important to note that these studies highlight the fact that the problem is not limited to the trade finance activities in which FIs are directly involved but that any process to move money through the banking system by simple payment may be dressed up as a means of financing trade in order to disguise the true underlying (and potentially illegal) activity. These studies also highlight the importance of the roles of all stakeholders, not just FIs.

The use of trade finance to obscure the illegal movement of funds includes methods to misrepresent the price, quality or quantity of goods.

Generally these techniques rely upon collusion between the seller and buyer since the intended outcome from the arrangements is obtaining value in excess of what would be expected from an arm's length transaction. The collusion may well arise because both parties are controlled by the same persons. The transfer of value in this way may be accomplished in a variety of ways which are described briefly below:

- 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.

- 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 FI 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 FIs or to other third parties which 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.

Making a determination as to whether over-invoicing or under-invoicing (or any other circumstances where there is misrepresentation of value) may be involved cannot be based on the trade documentation itself. Nor is it feasible to make such determinations on the basis of external data bases; most products are not traded in public markets, and there are therefore no publicly available market prices.

Even in transactions involving regularly traded commodities subject to publicly available market prices, FIs generally are not in a position to make meaningful determinations about the legitimacy of unit pricing due to the lack of relevant business information, such as the terms of a business relationship, volume discounting, specific quality of the goods involved, etc.

Moreover, notwithstanding that in certain limited circumstances FIs may gain some of this business information, it would be reasonable for them to do so only in the specific, highly-structured transactions at issue rather than generally.

However, there may be situations where unit pricing appears manifestly unusual, which should prompt appropriate enquiries to be made.

(b) Assessment of Risks

As with their other lines of business, services and products, FIs should apply a risk based approach to the assessment and management of risk in relation to trade finance. In this connection the Wolfsberg Group has issued general guidance on a Risk Based Approach which is considered relevant in the context of trade finance.

The assessment of risk and application of appropriate AML controls will also depend on the role of an FI in any trade transaction.

As trade finance transactions may involve a number of FIs there will be a considerable degree of apportionment between these institutions in respect of their responsibility to conduct underlying due diligence on their respective customers. A number of these FIs may be correspondents of one another and therefore the principles espoused in the Wolfsberg AML Principles for Correspondent Banking will be relevant.

(c) Application of controls

FIs review trade transactions on an individual basis. Generally transactions are examined for the application of the ICC rules referred to above and for their workability in terms of whether the conditions as documented conform with international standard banking practice as well as what is known of the customer. This review is used to examine the transaction not only for fraud but also for unusual and potentially suspicious activities. The complex paper based nature of these transactions provides a large amount of information about the parties, goods and services being transferred and involves scrutiny of the relevant documents. Whilst certain elements of this process may be automated (e.g. screening of transactions against published lists of sanctioned entities) the overall process of reviewing trade documents by its nature cannot be successfully automated.

Such controls are relevant in the context of anti-money laundering and counter-terrorist financing efforts (but only to the extent that terrorist financing involves criminal activities/money laundering). The most effective means by which to identify terrorist involvement in trade finance transactions is for competent authorities to identify those individuals and organizations connected to terrorist activities and provide that information to FIs in a timely manner. Accordingly, trade finance controls consisting of screening part of the transactional information against lists of known or suspected terrorists issued by competent authorities having jurisdiction over the relevant FI are relevant in the context of anti-terrorist financing efforts.

More specific guidance with regard to the nature and extent of controls that should be applied by the various FIs in relation to the underlying parties to the transaction and the documentation are set out in the appendices. Appendix I deals with LCs and Appendix II deals with BCs.

5. Sanctions and Non Proliferation Weapons of Mass Deastruction (NPWMD)

(a) Risks

There are a variety of United Nations (UN) and national or regional sanctions in place. These include:

- Country based financial sanctions that target specific individuals and entities
- Trade based sanctions e.g. embargos on the provision of certain goods, services or expertise to certain countries.

In recent years 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 WMD proliferation.

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

International trade is an enormous global endeavour, both in terms of monetary value as well as the volume of transactions, involving trillions of dollars and millions of individual transactions of relatively small monetary value. The ability of any one FI to understand who the ultimate buyer (or seller) of a product is, or what the ultimate end use of that product may be, is severely limited. This understanding will be even more limited where transactions are part of a complex structure.

It is recognised that in the area of activity based-sanctions relating to WMD a considerable amount of research and consultation between all interested parties in the public and private sections is required. This collaboration will help to develop legislation/regulation as well as the provision of guidance to FIs and implementation of commensurate controls. The Wolfsberg Group supports continuing dialogue between all relevant stakeholders as set out in section 6 of this paper.

(b) Risk Assessment

The greatest risk involved in relation to breach of sanctions and the proliferation of WMD is the use of intermediaries and other means to hide the ultimate end user of a product, or the ultimate application/use of a product. Transactions involving multiple parties and transfers of ownership may disguise the true nature of a transaction.

The use of trade finance for breach of sanctions and/or the proliferation of WMD could potentially take advantage of the complex and fragmented nature of existing global finance

activity where multiple parties (many times unknown to one another) become involved in the handling of trade finance.

(c) Application of Controls

The application of existing and appropriate AML controls is also considered relevant for the purpose of complying with sanctions and NPWMD.

More specific guidance with regard to the nature and extent of controls that should be applied together with a description of the limitations faced by FIs are set out in Appendix III.

6. National and Global Co-Operation

There has already been discussion and debate between relevant stakeholders at both a national and international level to counter the threat of money laundering in the trade finance area.

The need for on-going co-operation is considered even more critical in respect of ensuring that breaches of targeted and/or activity based sanctions are not facilitated through trade finance activities.

Stakeholders may include national bodies such as Governments, Law Enforcement Agencies, Financial Intelligence Units, Regulators, Export Credit Agencies, Customs and Excise, Tax Authorities, Shipping Agents, Carriers, Port Authorities, as well as international agencies such as the ICC Task Force on Money Laundering and FATF.

The Wolfsberg Group has identified the following areas for further consultation and/or the introduction of appropriate controls and this co-operation will aid the contribution FIs are able to make and will enhance controls more generally.

- The provision and maintenance by relevant government authorities of up to date suitably standardised lists of sanctioned entities and individuals, including appropriate biographical and other relevant information to facilitate (a) effective screening and searching against customer data bases and (b) efficient and effective screening of transactions by FIs.
- The provision of details by relevant government authorities in a manner that can be understood by non-experts in respect of products and materials that may have “Dual Purpose” properties. These details should ideally be capable of being integrated into electronic processing systems.
- The availability of “Help Desks” within relevant government authorities to respond to queries of a technical nature in relation to sanctions and in particular Dual Purpose goods. Such responses must be timely enough to not adversely impact the bank’s obligations under the trade transaction or alert potential perpetrators.

- Co-operation by the relevant agencies, including enforcement agencies regulators etc., at an international level to permit greater uniformity in relation to the application of AML, Sanctions and NPWMD regimes.
- The publication by the relevant authorities of the names of individuals and entities that have been denied export licences or who have been involved in criminal activities, including corruption, involving trade finance.
- The continuation of dialogue between the public and private sectors in relation to the identification and dissemination of typologies and pre/post event risk indicators in respect of trade finance.
- The provision and maintenance by the authorities of up to date information in respect of the patterns, techniques and routes used by criminals and others to launder money, fund terrorism and breach sanctions in the trade finance area

Wolfsberg Trade Finance Principles Paper

Appendix I

AML Guidance in relation to Letters of Credit (LCs)

(Within this appendix, reference to Banks rather than FIs will be used given the need to refer to Banks in an accepted technical context in relation to LCs)

Introduction

The Trade Finance Principles Paper sets out the background to trade finance and addresses the AML/CTF/Sanctions risks. The paper also comments on the application of controls in general and makes some observations on the subject of future co-operation between relevant stakeholders. This appendix provides guidance on the specific application of controls by Banks in the context of LCs and is intended to reflect standard industry practice. In order to fully illustrate these controls the appendix uses a simplified scenario and then describes in some detail the control activities applied by the Banks involved. Where appropriate, any variations on the simplified scenario will be addressed.

Controls which are described fall into the following broad categories:

- Due Diligence: Used here to describe both the process for identifying and knowing the customer but also for risk based checks in relation to parties who may not be customers. Given the range of meanings applied reference will be made as necessary to “appropriate due diligence” (which may consist of risk based checks only).

- Reviewing: Defined here as any process (often not automated) to review relevant information in a transaction relating to the relevant parties involved, documentation presented and instructions received.. As will also be described under the Risk Indicators section certain information can and should be reviewed and checked before transactions are allowed to proceed.
- Screening: A usually automated process to compare information against reference sources such as terrorist lists. Screening is normally undertaken at the same time as reviewing and prior to the completion of the specific activity subject to review. It may also be undertaken at the same time as, or as part of, due diligence
- Monitoring: Any activity to review completed or in progress transactions for the presence of unusual and potentially suspicious features. For trade transactions it should be recognised that it is impossible to introduce any standard patterning techniques in relation to account/transactional monitoring processes or systems. This is due to the range of variations which are present even in normal trading patterns.

A summary of the key control activities is provided in tabular form at the end of this appendix.

It is important to note that with LCs the banks typically operate in accordance with ICC Publication No. 600 – Uniform Customs and Practice for Documentary Credits. The extent of reviewing activity which banks carry out is determined by their responsibilities as defined within these internationally accepted rules.

Commercial practices and industry standards determine finite timescales in which to act.

In determining whether transactions are unusual due to over or under invoicing (or any other circumstances where there is misrepresentation of value) it needs to be understood that Banks are not generally equipped to make this assessment.

For Banks involved in processing LCs, the knowledge and experience of their trade staff must therefore serve as the first and best line of defence against criminal abuses of these products and services. Reviewing trade documentation is a highly manual process, requiring that the commercial documents that are presented for payment are compared against the terms and conditions of the LC in accordance with the applicable ICC rules and standard international banking practice.

Potentially there are a large number of risk indicators. Against this background it is important to distinguish between

1. Information which must be validated before transactions are allowed to proceed or complete and which may prevent such completion. (e.g., a terrorist name, UN sanctioned entity).

2. Information which ought to be used in post event analysis as part of the investigation and suspicious activity reporting process.

Activity or information connected with the LC

Deal structures:

- Beyond capacity/substance of customer
- Improbable goods, origins, quantities, destination
- Unusual complexity/unconventional use of financial products /Goods
- Applicable import or export controls regulations may not be complied with Goods
- Totally out of line with customers known business
- Countries/names On the Sanctions/terrorist list
- Countries On the Bank's high risk list
- Any attempt to disguise/circumvent countries involved in the actual trade

Payment instructions:

- Illogical
- Last minute changes
- Repayment arrangements
- Third parties are funding or part funding the LC value (just in time account credits to the settlement account)

LC patterns:

- Constantly amended/extended
- Routinely cancelled/ unutilised

LC Counterparties:

- Connected applicant/beneficiary
- Applicant documentation controls payment

Discrepancies in documents (not necessarily grounds for rejection under UCP600)

- · Goods descriptions differ significantly
- · Especially invoice vs shipping doc

- · Unexplained third parties

Discrepancies waived:

- Advance waivers provided
- · Absence of required transport documents
- Significantly overdrawn LC

Wolfsberg Trade Finance Principles Paper

Appendix II

AML Guidance in relation to Bills for Collection (BCs)

(Within this Appendix, reference to Banks rather than FIs will be used given the need to refer to Banks in an accepted technical context in relation to BCs)

Introduction

The Trade Finance Principles Paper sets out the background to trade finance and addresses the AML/CTF/Sanctions risks. The paper also comments on the application of controls in general and makes some observations on the subject of future co-operation between relevant stakeholders. This appendix provides guidance on the specific application of controls by Banks in the context of BCs and is intended to reflect standard industry practice. In order to fully illustrate these controls the appendix uses a simplified scenario and then describes in some detail the control activities applied by the Banks involved. Where appropriate, any variations on the simplified scenario will be addressed.

Controls which are described fall into the following broad categories:

- Due Diligence: Used here to describe both the process for identifying and knowing the customer but also for risk based checks in relation to parties who may not be customers. Given the range of meanings applied reference will be made as necessary to “appropriate due diligence”, which may consist of risk based checks only.
- Reviewing: Defined here as any process (often not automated) to review relevant information in a transaction relating to the relevant parties involved, documentation presented and instructions received. As will also be described under the Risk Indicators section certain information can and should be reviewed and checked before transactions are allowed to proceed.
- Screening: A usually automated process to compare information against reference sources such as terrorist lists. Screening is normally undertaken at the same time as

reviewing and prior to the completion of the specific activity subject to review. It may also be undertaken at the same time as, or as part of, due diligence

- Monitoring: Any activity to review completed or in progress transactions for the presence of unusual and potentially suspicious features. For trade transactions it should be recognised that it is impossible to introduce any standard patterning techniques in relation to account/transactional monitoring processes or systems. This is due to the range of variations which are present even in normal trading patterns.

It is important to note that with BCs banks operate in accordance with ICC Publication No. 522 – Uniform Rules for Collections. The extent of reviewing activity which banks carry out is determined by their responsibilities as defined within these internationally accepted rules. These rules are fundamentally different to the rules governing LCs (refer to Appendix I)

Enhanced Due Diligence

An enhanced due diligence process should be automatically applied where the applicant falls into a higher risk category or where the nature of their trade as disclosed during the standard due diligence process suggests that enhanced due diligence would be prudent. The enhanced due diligence should be designed to understand the trade cycle and may involve establishing

- The countries where Applicant trades
- The goods traded
- The type and nature of principal parties with whom the Applicant does business.

Wolfsberg Trade Finance Principles Paper

Appendix III

AML Guidance in relation to Guarantees (Gtees) and Standby Letters of Credit (SBLCs)

(Within this appendix reference to Banks rather than FIs will be used given the need to refer to Banks in an accepted technical context in relation to Gtees and SBLCs)

Introduction

The Trade Finance Principles Paper sets out the background to trade finance and addresses the AML/CTF/Sanctions risks. The paper also comments on the application of controls in general and makes some observations on the subject of future co-operation between relevant stakeholders. This appendix provides guidance on the specific application of controls by Banks in the context of Gtees and SBLCs and is intended to reflect standard industry practice. In order to fully illustrate these controls the appendix uses a simplified scenario and then describes in some

detail the control activities applied by the Banks involved. Where appropriate, any variations on the simplified scenario will be addressed.

SBLCs and Gtees are different from Documentary Letters of Credit (LCs) in that while the LC is a performance-related payment instrument (i.e., once the seller has performed and presents the required documentation, the LC can be drawn upon and payment made), both Gtees and SBLCs are instruments to secure a compensation payment to the beneficiary only in the case of non-performance(e.g., the SBLC or Gtee can provide for compensation to either

(a) a buyer for the seller's failure to provide the contracted goods or services in accordance with specified timelines or other performance measures or

(b) to a seller where the buyer fails to make regular payment under a sales contract). Under some circumstances, usually unrelated to the movement of goods or services, SBLC's may function as both a payment instrument and an assurance of payment. Unlike LCs and BCs, these instruments are not designed to facilitate payment, but only to provide a security for a compensation payment if there is a failure to perform in accordance with specified criteria. Normally, performance takes place as contemplated, in which case no claim is made and no payment (other than bank charges) is affected. SBLCs are distinguishable from Gtees in that SBLCs usually only require a simple demand for payment along with a statement of default and is subject to either ISP98 or UCP600; while Gtees more often require a simple demand with possibly a statement of the nature of the default or claim. Use of a Gtee versus an SBLC may also vary based on local law or prevailing business practice.

Gtees and SBLCs may take many forms, including those issued in support of the supply of goods or services (Performance Bonds, Advance Payment Guarantees, Tender Bonds, Bid Bonds), and those used to secure a purely financial obligation (Counter Indemnities, such as the repayment of credit facilities or the payment of leasing fees). They may be issued in connection with the supply of utilities such as water, power, etc. they are also used in support of bond issues, licences to operate, etc. as part of the contract terms.

It should therefore be recognised that many SBLCs/Gtees issued are not related to the Trade Finance activities as defined within The Trade Finance Principles Paper .The risk control framework for Gtees and SBLCs is, however to a certain extent, similar to that applicable to LCs, in that when a Gtee or SBLC is issued, the risk control framework should generally have elements adequate to identify

1) the nature of the counterparty relationship,

2) the reasonableness of the underlying transaction when compared with the business operations of the counterparties, and

3) whether either the underlying activity or the counterparties to the activity are sanctioned by relevant authorities. Differences in the application of such a control framework arise; however, because LC-related risk control frameworks typically contemplate payments as the expected result of the business process, whereas in the context of SBLCs and Gtees, payments would be the exception. Risk controls specific to situations where Gtees and SBLCs are drawn upon or paid should also generally address sanctions and appropriateness issues.

Controls which apply (i.e. Due Diligence, Reviewing, Screening and Monitoring) are largely the same as defined in the Appendix relating to LCs.

A summary of the key control activities is provided in tabular form at the end of this appendix. For further reference some of the terms used in this guidance are defined in the glossary of terms forming Appendix IV.

It is important to note that with SBLCs the banks operate in accordance with ICC Publication No. 600 – Uniform Customs and Practice for Documentary Credits, or Publication 590 – International Standby Practices ISP98. Guarantees may follow the ICC Uniform Rules for Demand Guarantees ICC Publication 758 or otherwise simply be subject to a national law. The extent of reviewing activity which banks carry out is determined by their responsibilities as defined within these internationally accepted rules. ISP98 and URDG758 are different to UCP600and where SBLCs are issued subject to the UCP, because UCP was designed primarily for LCs, exclusions and variations are often used.

For Banks involved in processing SBLCs and Gtees, the knowledge and experience of their operations staff must therefore serve as the first and best line of defence against criminal abuses of these products and services. Reviewing SBLC or Gtee documentation is a highly manual process, requiring that the claim and any supporting documents that may be presented for payment are compared against the terms and conditions of the SBLC or Gtee and where applicable any ICC rules and standard international banking practice. Potentially there are a large number of risk indicators. Against this background it is important to distinguish between Information which must be validated before transactions are allowed to proceed or complete and which may prevent such completion. (e.g., a terrorist name, UN sanctioned entity). Information which ought to be used in post event analysis as part of the investigation and suspicious activity reporting process. Appended below is a list of some of the risk indicators which might become apparent in the handling of an SBLC/Gtee transaction. This table does not contain the full range of risk indicators which might apply generally across the customer / bank relationship, but is specifically targeted to cover some of the risk indicators related to the processing of an SBLC/Gtee transaction. It is also important to note that some risk indicators will only become apparent after the transaction has taken place and will only be known to law enforcement or financial investigation units as part of their formal investigation processes.

AML Guidance in relation to Open Account Trade Transactions

Appendix IV

The Trade Finance Principles Paper sets out the background to trade finance and addresses the AML/CTF/Sanctions risks. The paper also comments on the application of controls in general and makes some observations on the subject of future co-operation between relevant stakeholders. This appendix provides explains the application of controls by Banks in the context of Open Account Trade

Open Account, involves the movement of goods or services between two companies, either domestically or internationally, based on mutual trust. Third-party intermediation to provide payment financing or performance risk mitigation is not deemed to be required because of the relationship between the two parties. Many corporations view open account trade as the least expensive way to handle trade-related payments, as it does not incur the costs involved with bank-provided financing or performance risk mitigation services.

In a typical Open Account transaction, the seller and the buyer contract for the delivery of stated goods from the seller to a place designated by the buyer. The type of contract used for the transaction will depend on the relationship between the buyer and seller; in most consumer good transactions, the standard contract of the buyer's group will apply. As part of the contracting process, the two parties will generally agree on the terms and method of payment.

Participants to an Open Account trade transaction do not look to banks to provide financing related to each specific purchase, and generally finance the transaction out of their own cash flow. Banks will likely be indirectly involved in the financing of the trade transaction through bank-provided overdraft facilities or revolving lines of credit, but will not have information as to the specifics of the trade transaction.

Banks are rarely involved in an Open Account trade transaction until a clean payment is made at the end (which could be after the goods have been delivered). The seller and buyer will generally not provide the banks handling the Open Account payment with supporting documentation; in the majority of cases, banks will have little inherent opportunity, need or cause to understand the nature of the underlying trade transaction, or to review any trade-related documentation (e.g., contracts, invoices).

Banks involved in handling a payment related to an Open Account trade transaction generally do so in one (or both) of two capacities:

1) The seller or buyer is their commercial customer, in which case they are debiting or crediting the account of a customer for which they would be expected to have conducted a certain amount of existing due diligence; and/or

2) The seller or buyer is the commercial customer of the bank's correspondent banking customer, in which case the bank would not necessarily have any general knowledge about the expected behaviour of their correspondent's customers.

The nature of the international payments system is such that banks will generally not be able to differentiate a payment related to an Open Account trade transaction from other clean payments when presented as an application to make a payment or to credit the account of the beneficiary. Banks handling trade-related payments will be able to perform the basic screening and monitoring related to payments transactions, but they will not, given the absence of availability of underlying transactional information, generally be in a position to otherwise discern suspicious activity.

Banks offering proprietary Open Account facilitation mechanisms (i.e., purchase order management capabilities, invoice discounting services, payment preparation and delivery suites) may, however, have greater insight into underlying trade transactions, up to complete visibility of trade documents and transaction flows, in which case the banks should use a risk-based approach in determining appropriate screening and monitoring systems.

Guidance in relation to Sanctions, including Non Proliferation, Weapons of Mass Destruction and Dual Use Goods (NP WMD)

Appendix V

Introduction

The Trade Finance Principles Paper sets out as one of its objectives the provision of some guidance on this difficult subject. The preceding Appendices I, II, III and IV dealing with LCs, BCs, SBLCs and Open Account set out the extent to which banks already address the problems posed by sanctions, named terrorists and applicable export controls, where known, in the context of all the activities they undertake.

Sanctions exist in various forms both nationally and internationally. Some of these directly concern NPWMD.

This appendix highlights the control mechanisms considered most relevant to Banks and should be read in conjunction with the guidance on money laundering and terrorist financing (AML) risks within the principles paper and the other appendices.

The FATF Proliferation Report (June 2008) is a significant reference source. It identifies the important role of a number of stakeholders and acknowledges the difficulties which FIs face in detecting proliferation financing.

Customer Due Diligence

It is not proposed to repeat the detail here, but clearly the due diligence process in relation to customers represents an important control and is one which is expected to be enhanced where higher risk circumstances are recognised

Name Screening

The application of AML controls provides a good foundation for sanctions controls. Banks generally have in place screening systems or processes which are designed to match the name related data which they process against relevant (so called “bad guy”) lists. This process can be applied to ensure that the transactions described in the earlier appendices do not

- involve as a principal party a target of UN or applicable local sanctions against named individuals and entities.
- result in a payment to such a target

In order to achieve this Banks need to refer to relevant external sources or subscribe to competent information providers. Clearly the effectiveness of this control is dependent upon the accuracy, quality and usability of the source lists which contain the details of target names. A very substantial practical issue already faced by banks is the volume of false hits which can occur in their payment systems as a result of automated screening. A false hit is where a partial or unconfirmed match occurs between the bank data and the data in the bad guy list. A partial match will occur where target names have similar or common elements with non-targets. An unconfirmed match would occur if the names match, but investigation confirms that the underlying identities are not the same.

Activity based financial sanctions

Where the target of the relevant sanctions is not specifically identified by name this makes any effective screening of a transaction by banks exceptionally difficult, whether automated or manual processes are used.

Banks should of course be aware of UN resolutions in relation to the proliferation of nuclear weapons, WMD, Dual Use Goods and of relevant local legislation which translates these into national laws or regulations.

Guidance on this is also issued by FATF and in regions where an export licensing control regime is in place by the relevant authorities. Other programmes address the more conventional threat from missiles, chemical weapons and related activity.

Available sources include the following:

- The Wassenaar Arrangement which has been established in order to contribute to regional and international security and stability, by promoting transparency and greater responsibility in transfers of conventional arms and dual-use goods and technologies

http://www.wassenaar.org/controllists/index.html

- UN Security Council Resolution 1737 (2006)http://www.un.org/Docs/sc/unsc_resolutions06.htm

and the supporting documents referred to therein.

http://www.iaea.org/DataCenter/index.html

- FATF Guidance regarding the implementation of financial provisions of UNSCRs to counter the proliferation of WMDs (June 2007)

FATF Guidance regarding the implementation of activity-based financial provisions of UNSCR 1737 (October 2007)

FATF report on Proliferation Financing (June 2008)

FATF Combating Proliferation Financing: Status Report on Policy Development and Consultation (February 2010)

http://www.fatf-gafi.org/

Banks should to the extent possible use the available information in relation to parties giving them instructions, goods and the countries involved. It should however be recognised that any practical application of this information may be severely limited.

Export Controls

It is the commercial counterparties to a trade transaction that, in the first instance, should determine whether an export license is required and that should obtain such a license if it is required. FIs are generally not in a position to determine, at any stage in a trade transaction, whether an export license is required, or whether the commercial counterparties to the trade have obtained a valid export licence.

The documentation required for preparing a trade financing arrangement rarely contains a detailed description of the product, much less information as to whether there exist any third-country licensing requirements attached to the product. Relevant government agencies, on the other hand, may be in a position to determine the need for any necessary license and to verify whether it has been duly obtained.

Where highly structured trade finance transactions are concerned or and enhanced due diligence is conducted as a matter of routine it may be appropriate for the FIs involved to obtain appropriate assurances that export licensing requirements have been satisfied

Limitations

The challenge, particularly in relation to activity based financial sanctions is considerable. The following points are particularly relevant.

- Payments made through banks in support of open account trade (which accounts for some 80% of all international trade) can only be screened by reference to the disclosed name data.
- The successful facilitation of international trade relies on the adherence to recognised international banking standards. Following the initial customer due diligence and once a customer transaction has been accepted and initiated the remaining activities conducted by the participating banks need to be completed within certain timescales.
- Information or details within the documentation presented to banks may be insufficient to disclose the exact nature of the transaction.
- When handling BC s in particular a detailed examination of documents accompanying the BC is not possible. This is fundamentally different from the position under LCs, SBLCs and Gtees
- Interpretation of “dual use” requires a degree of technical knowledge that LC , SBLC and Gtee document checkers cannot be expected to possess. In addition, goods descriptions 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, without the necessary technical qualifications and knowledge across a wide range of products and goods the ability of a bank to understand the varying applications of dual use goods will be virtually impossible. It would be impracticable for Banks to employ departments of specialists for this purpose as in doing so they would need to replicate comprehensive scientific research facilities.

Countries known to be involved directly may be named in sanctions but countries which are technology producers or are “diversion risk” countries used for the transit or re-export of goods may well not appear on any warning lists.

Conclusion

As explained in section 6 of the Principles Paper, banks are only one of the relevant stakeholders. Whilst Banks are a primary conduit for the movement of funds substantial participation from other key stakeholders is required in order to provide an effective deterrence effort and to aid the detection/s discovery of the relevant targets in this area.

Guidance in relation to Sanctions, including Non Proliferation, Weapons of Mass Destruction and Dual Use Goods (NP WMD)

Appendix V

Introduction

The Trade Finance Principles Paper sets out as one of its objectives the provision of some guidance on this difficult subject. The preceding Appendices I, II, III and IV dealing with LCs, BCs, SBLCs and Open Account set out the extent to which banks already address the problems posed by sanctions, named terrorists and applicable export controls, where known, in the context of all the activities they undertake.

Sanctions exist in various forms both nationally and internationally. Some of these directly concern NPWMD.

This appendix highlights the control mechanisms considered most relevant to Banks and should be read in conjunction with the guidance on money laundering and terrorist financing (AML) risks within the principles paper and the other appendices.

The FATF Proliferation Report (June 2008) is a significant reference source. It identifies the important role of a number of stakeholders and acknowledges the difficulties which FIs face in detecting proliferation financing.

Customer Due Diligence

It is not proposed to repeat the detail here, but clearly the due diligence process in relation to customers represents an important control and is one which is expected to be enhanced where higher risk circumstances are recognised

Name Screening

The application of AML controls provides a good foundation for sanctions controls. Banks generally have in place screening systems or processes which are designed to match the name related data which they process against relevant (so called “bad guy”) lists. This process can be applied to ensure that the transactions described in the earlier appendices do not

- involve as a principal party a target of UN or applicable local sanctions against named individuals and entities.

- result in a payment to such a target

In order to achieve this Banks need to refer to relevant external sources or subscribe to competent information providers. Clearly the effectiveness of this control is dependent upon the accuracy, quality and usability of the source lists which contain the details of target names. A very substantial practical issue already faced by banks is the volume of false hits which can occur in their payment systems as a result of automated screening. A false hit is where a partial or unconfirmed match occurs between the bank data and the data in the bad guy list. A partial match will occur where target names have similar or common elements with non-targets. An unconfirmed match would occur if the names match, but investigation confirms that the underlying identities are not the same.

Activity based financial sanctions

Where the target of the relevant sanctions is not specifically identified by name this makes any effective screening of a transaction by banks exceptionally difficult, whether automated or manual processes are used.

Banks should of course be aware of UN resolutions in relation to the proliferation of nuclear weapons, WMD, Dual Use Goods and of relevant local legislation which translates these into national laws or regulations.

Guidance on this is also issued by FATF and in regions where an export licensing control regime is in place by the relevant authorities. Other programmes address the more conventional threat from missiles, chemical weapons and related activity.

Available sources include the following:

- The Wassenaar Arrangement which has been established in order to contribute to regional and international security and stability, by promoting transparency and greater responsibility in transfers of conventional arms and dual-use goods and technologies

http://www.wassenaar.org/controllists/index.html

- UN Security Council Resolution 1737 (2006)http://www.un.org/Docs/sc/unsc_resolutions06.htm

and the supporting documents referred to therein.

http://www.iaea.org/DataCenter/index.html

- FATF Guidance regarding the implementation of financial provisions of UNSCRs to counter the proliferation of WMDs (June 2007)

FATF Guidance regarding the implementation of activity-based financial provisions of UNSCR 1737 (October 2007)

FATF report on Proliferation Financing (June 2008)

FATF Combating Proliferation Financing: Status Report on Policy Development and Consultation (February 2010)

http://www.fatf-gafi.org/

Banks should to the extent possible use the available information in relation to parties giving them instructions, goods and the countries involved. It should however be recognised that any practical application of this information may be severely limited.

Export Controls

It is the commercial counterparties to a trade transaction that, in the first instance, should determine whether an export license is required and that should obtain such a license if it is required. FIs are generally not in a position to determine, at any stage in a trade transaction, whether an export license is required, or whether the commercial counterparties to the trade have obtained a valid export licence.

The documentation required for preparing a trade financing arrangement rarely contains a detailed description of the product, much less information as to whether there exist any third-country licensing requirements attached to the product. Relevant government agencies, on the other hand, may be in a position to determine the need for any necessary license and to verify whether it has been duly obtained.

Where highly structured trade finance transactions are concerned or and enhanced due diligence is conducted as a matter of routine it may be appropriate for the FIs involved to obtain appropriate assurances that export licensing requirements have been satisfied

Limitations

The challenge, particularly in relation to activity based financial sanctions is considerable. The following points are particularly relevant.

- Payments made through banks in support of open account trade (which accounts for some 80% of all international trade) can only be screened by reference to the disclosed name data.
- The successful facilitation of international trade relies on the adherence to recognised international banking standards. Following the initial customer due diligence and once a

customer transaction has been accepted and initiated the remaining activities conducted by the participating banks need to be completed within certain timescales.

- Information or details within the documentation presented to banks may be insufficient to disclose the exact nature of the transaction.
- When handling BC s in particular a detailed examination of documents accompanying the BC is not possible. This is fundamentally different from the position under LCs, SBLCs and Gtees
- Interpretation of “dual use” requires a degree of technical knowledge that LC , SBLC and Gtee document checkers cannot be expected to possess. In addition, goods descriptions 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, without the necessary technical qualifications and knowledge across a wide range of products and goods the ability of a bank to understand the varying applications of dual use goods will be virtually impossible. It would be impracticable for Banks to employ departments of specialists for this purpose as in doing so they would need to replicate comprehensive scientific research facilities.

Countries known to be involved directly may be named in sanctions but countries which are technology producers or are “diversion risk” countries used for the transit or re-export of goods may well not appear on any warning lists.

Conclusion

As explained in section 6 of the Principles Paper, banks are only one of the relevant stakeholders. Whilst Banks are a primary conduit for the movement of funds substantial participation from other key stakeholders is required in order to provide an effective deterrence effort and to aid the detection/s discovery of the relevant targets in this area.