INTRODUCTION TO TRADE-BASED MONEY LAUNDERING

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NOTABLE QUOTE

"There is no such thing as good money or bad money – there is just money."

- Charlie "Lucky" Luciano

WHAT IS TRADE-BASED MONEY LAUNDERING?

- The process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimize their illicit origins.

WHAT IS TRADE FINANCE?

- Trade finance typically involves short-term financing to facilitate the import and export of goods.
- Trade finance can involve payment if documentary requirements are met (e.g., letter of credit), or may involve payment if the original obligor defaults on the commercial terms of the transactions (e.g., guarantees or standby letters of credit).
  - In both cases, a bank's involvement in trade finance minimizes risk to importers and exporters.
- International trade relies heavily on the letter of credit as a means of effecting payment on delivery of goods.

PARTICIPANTS IN TRADE FINANCE TRANSACTIONS

- Applicant: The buyer (importer) or the party who requests the issuance of a letter of credit.

- Issuing Bank: Issues the letter of credit on behalf of the Applicant and forwards it to the Advising Bank for notification to the Beneficiary. The Applicant is the Issuing Bank's customer.

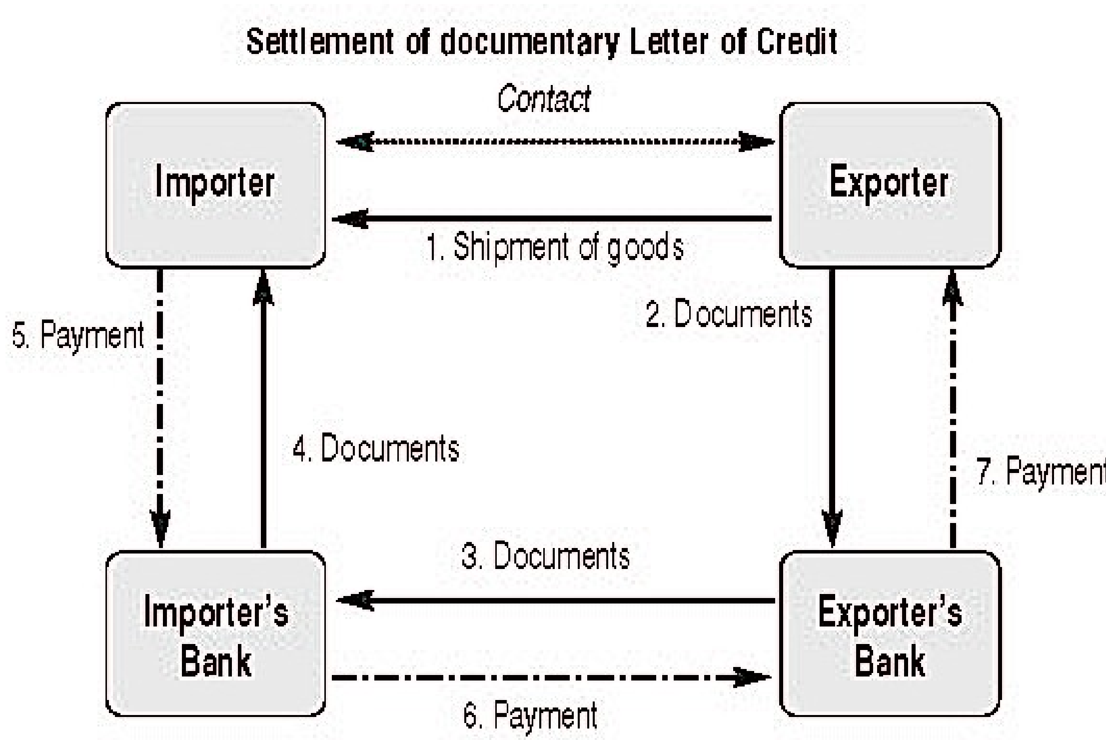
- Confirming Bank: Typically in the country of the Beneficiary, at the request of the Issuing Bank, joins the Issuing Bank in honoring draws made by the Beneficiary, provided the terms and conditions of the letter of credit are met.

- Advising Bank: Branch or correspondent bank near the Beneficiary's domicile, to which the Issuing Bank sends the letter of credit or notification of its issuance, with instructions to notify the Beneficiary. The Advising Bank advises the Beneficiary without taking other active engagement in the letter of credit.

PARTICIPANTS IN TRADE FINANCE TRANSACTIONS

- Beneficiary (Drawer): The seller (Exporter) or party to whom the letter of credit is addressed.
- Negotiating Bank: Usually the Beneficiary's bank agrees to purchase the draft and pay the Beneficiary after satisfying itself that documentary requirements have been met.
- Accepting Bank: Incurs a legal obligation to pay the draft at maturity. Drafts are drawn on the Accepting Bank that dates and signs the instrument.
- Discounting Bank: Discounts a draft for the Beneficiary after it has been accepted by an Accepting Bank.
- Reimbursing Bank: Authorized by the Issuing Bank to reimburse the Drawee Bank submitting claims under the letter of credit.
- Paying (Drawee) Bank: As named in the letter of credit, the bank where drafts are to be paid. The Paying Bank is typically the Issuing Bank but is often a branch or correspondent of the Issuing Bank. Once paid or accepted by the Paying Bank or Drawee Bank, there is no recourse to the drawers.

LETTER OF CREDIT SETTLEMENT



FOUNDATION OF THE LC SYSTEM

- The letter of credit system is vitally important to the smooth operation of legitimate international trade.
- The LC system is based upon established principles (Uniform Customs & Practices) that collectively ensure that banks honor their obligations to pay.
- The only requirement is that the documentation provided by the Beneficiary must be in compliance with the terms of the letter of credit.
  - If the documents comply the bank must pay.
  - This rule applies even in cases where banks have been informed that there are suspicions of fraud.
- Although a fraud exception allows a bank to refuse payment, the bank <u>must</u> have actual knowledge of the fraud.

RISK FACTORS

- Banking is a risk-taking business and most banks are well equipped to deal with the typical risks such as credit risk, transaction risk, etc..

- Due to a general lack of training and experience, most bankers (as well as regulators and law enforcement) do not adequately consider money laundering and terrorist financing risk in trade transactions.

- The involvement of multiple parties can make the process of due diligence more difficult.

- Since trade financing is generally more document based than other banking activities, it can be susceptible to document fraud, which can be linked to money laundering, terrorist financing or the circumvention of OFAC sanctions and other prohibitions.

TRADE-BASED MONEY LAUNDERING AND DOCUMENTARY FRAUD

- Documentary Fraud is an international trade fraud that is perpetrated under the guise of a trade finance transaction, using well-known banking instruments which are flawed by the fact that the trade finance transaction itself either does not exist or has been subject to criminal and fraudulent invasion.

THREE PRIMARY METHODS USED BY CRIMINALS AND TERRORISTS TO MOVE VALUE

1) Use of the financial system (checks, wire transfers, cash deposits, etc.)

2) Physical movement of money (cash couriers and bulk cash smuggling).

3) Physical movement of goods through trade system (false documentation).

WHY IS INTERNATIONAL TRADE THE NEW FRONTIER?

- Strict oversight of the financial system and of physical currency transport has been abundant and consistent, making trade-based money laundering the least risky of the three value transfer systems.

- Enormous volume of trade flows obscures individual transactions.

- Complex financial arrangements involving multiple foreign exchange transactions.

- Diverse trade financing arrangements

WHY IS INTERNATIONAL TRADE THE NEW FRONTIER?

- Ability to commingle legitimate and illicit funds
- Limited governmental and industry resources
- Criminals know that bankers generally lack knowledge of worldwide of prices of commodities, making transactions less susceptible to scrutiny.
- Focus on documentation and not actual goods and services when letter of credits are involved.
- Risk of detection is **low**.

HOW DOES TRADE-BASED MONEY LAUNDERING WORK

- Misrepresentation of price, quantity or quality of imports and exports.
- Trade transactions are usually combined with other money laundering techniques to further obscure the money trail
- Some estimates show $390 billion crossed U.S. borders through some form of trade-based money laundering in 2004.

ROLE OF FINANCIAL INSTITUTIONS

- Financial institutions can play three roles in the settlement of international trade transactions.
  - Money Transmission – The transfer of funds between parties associated with the trade transactions.
  - Provision of Finance – The provision of credit to support the trade transaction.
  - Lending the Financial Institution's Name –
    - Financial institution undertakes to make payment subject to certain conditions (e.g., letter of credit).
    - Financial institution undertakes to making payment if the buyer defaults (e.g., guarantee)

- All three roles expose the financial institution to regulatory and reputation risk (apart from normal risks) if transactions are not diligenced from the money laundering perspective.

BASIC TRADE-BASED MONEY LAUNDERING TECHNIQUES

- Over- and under-invoicing of good and services
- Multiple invoicing of goods and services
- Over- and under-shipment of goods and services
- Falsely described goods and services

OVER- AND UNDER-INVOICING

- Common techniques used to fraudulently move value across borders.

- UNDER-INVOICING: Involves invoicing the good or service at a price below the "fair market" price.
  - Exporter is able to transfer value to the importer, as the payment for the goods will be lower than the value the goods or service the importer receives when it is sold in the open market.

OVER-INVOICING

- OVER-INVOICING: Involves invoicing the good or service at a price above the fair market price.
  - Exporter is able to receive value from the importer, as the payment for the good or service is higher than the value that the importer will receive when it is sold on the open market.

OVER- AND UNDER-INVOICING

- This technique requires that both the exporter and importer agree to the arrangement (collusion). There is no innocent party to the transaction.
  - Importer and Exporter may be related or have common control.

- Under-Invoicing is one of the most common trade-based money laundering techniques used to move money.
  - Since the focus of most customs agencies is to stop the importation of contraband and collection of import duties, less focus is given to export transactions involving under-invoicing.

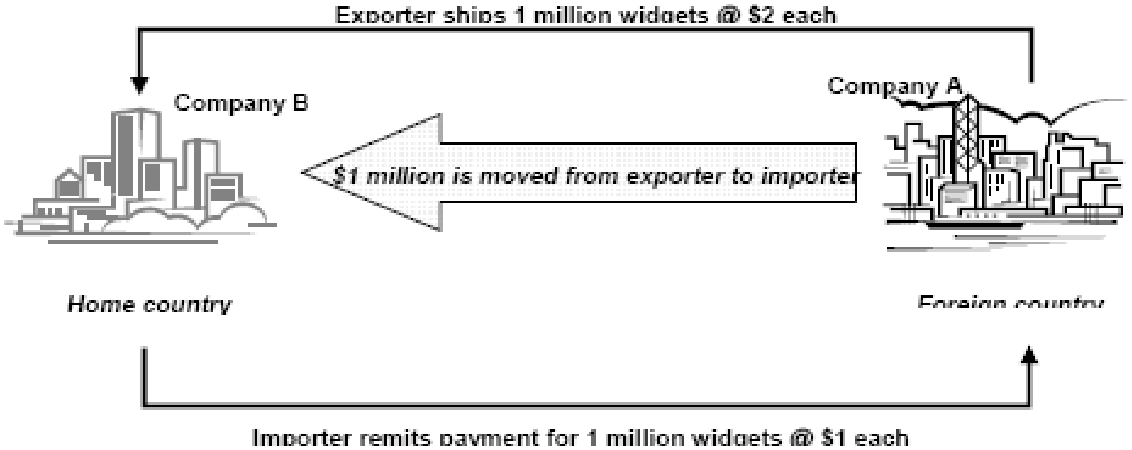
OVER- AND UNDER INVOICING

- The more complex the good being traded, the greater the difficulty in identifying over- and under-invoicing.
  - The ability to identify incorrectly priced goods is often limited to goods and services that are widely traded.

OVER AND UNDER INVOICING

Over- and Under-Invoicing of Goods – An Example

Company A (a foreign exporter) ships 1 million widgets worth $2 each, but invoices Company B (a colluding domestic importer) for 1 million widgets at a price of only $1 each. Company B pays Company A for the goods by sending a wire transfer for $1 million. Company B then sells the widgets on the open market for $2 million and deposits the extra $1 million (the difference between the invoiced price and the "fair market" value) into a bank account to be disbursed according to Company A's instructions.



Alternatively, Company C (a domestic exporter) ships 1 million widgets worth $2 each, but invoices Company D (a colluding foreign importer) for 1 million widgets at a price of $3 each. Company D pays Company C for the goods by sending a wire transfer for $3 million. Company C then pays $2 million to its suppliers and deposits the remaining $1 million (the difference between the invoiced price and the "fair market" price) into a bank account to be disbursed according to Company D's instructions.

OVER-INVOICING PRICES

ITEM	COUNTRY	PRICE
Multiple Vitamins	China	$ 1,868.77/kg
Plastic Buckets	Czech	$ 972.98/unit
Fence Posts – Treated	Canada	$ 1,853.50/meter
Wood Moldings	Bolivia	$ 1,124.17/meter
Toilet/Facial Tissue	China	$ 4,121.81/kg
Briefs and Panties	Hungary	$ 739.25/doz
Dishtowels of Cotton	Pakistan	$ 153.72/unit
Other Made-Up Articles	Arab Em	$ 106.73/unit
Unglazed Tiles – Ceramic	Italy	$ 4,480.00/sqmtr
Rubies – Cut, Not Set	Burma	$ 38,192.30/carat
Bolts – Iron or Steel	France	$ 3,067.17/kg
Threaded Nuts	Belgium	$ 2,426.70/kg
Tweezers – Base Metal	Japan	$ 4,896.00/unit
Lawnmower Blades	Australia	$ 2,326.75/unit
Razors	UK	$ 113.20/unit
Air Pumps – Hand/Foot Operated	Malaysia	$ 5,000.00/unit
Camshafts and Crankshafts	Saudi Arabia	$ 15,200.00/unit
Telephone Sets – One Line	Japan	$ 2,728.00/unit
Unrecorded Magnetic Disks	Denmark	$ 164.19/unit
Smoke Detectors – Battery Powered	Germany	$ 3,500.00/unit
Industrial Hand Trucks	Spain	$ 3,800.86/unit
Hypodermic Syringes	Switzerland	$ 142.78/unit

UNDER-INVOICING PRICES

ITEM	COUNTRY	PRICE
Bovine Animals - Live	Mexico	$ 20.65/unit
Multiple Vitamins	Finland	$ 1.34/kg
Dynamite	Canada	$ 1.24/kg
Radial Tires – Bus/Truck	UK	$ 11.74/unit
Diamonds – Not Industrial	India	$ 13.45/carat
Toilets - Bowls with Tanks, one piece	Hong Kong	$ 1.75/unit
Aluminum Ladders	Japan	$ 4.40/unit
Fork-Lifts, Self Propelled	Jamaica	$ 384.14/unit
Industrial Robots	Ireland	$ 324.37/unit
Bulldozers – Self-Propelled	Colombia	$ 1,741.92/unit
Automatic Teller Machines	France	$ 97.00/unit
Trash Compactors	UK	$ 54.82/unit
Video Monitors - Color	Pakistan	$ 21.90/unit
Video Projectors – Color	Brazil	$ 33.95/unit
Road Tractors – For Semi-Trailers	Nigeria	$ 3,750.00/unit
Truck Caps	Mexico	$ 10.77/unit
Cameras – SLR, 35mm	Colombia	$ 7.44/unit
Clinical Thermometers	Germany	$ 0.06/unit
Wrist Watches – Cases of Precious Metal	Colombia	$ 8.68/unit
Missile and Rocket Launchers	Israel	$ 52.03/unit
Prefabricated Buildings	Trinidad	$ 1.20/unit
Seats – For Motor Vehicles	Belgium	$1.66/unit

ABNORMAL PRICING

- Abnormal pricing is the term economists use to describe the manipulation of prices for the purpose of moving value in and out of a country undetected.

- Over- and under-invoicing are abnormal pricing techniques.

- Trade-based money laundering involves the use of abnormal pricing for the purpose of moving value connected with criminal activity across borders.

ABNORMAL PRICING

- Other reasons for abnormal pricing:
  - Lack of knowledge of worldwide prices.
  - Capital Flight (to move capital/investments out of a country undetected).
  - Import Duty Fraud (to reduce the amount of import duties paid).
  - Income Tax Evasion (to reduce the amount of income taxes paid).

EFFECT OF ABNORMAL PRICING

- US/GREECE 1995
  - Over-Invoicing estimated to move $132MM in value to U.S.
  - Under-Invoicing estimated to move $276MM in value to U.S.
- US/SWITZERLAND 1995-2000
  - Combined over/under invoicing estimated to move $31 billion in value to the U.S.

MULTIPLE INVOICING OF GOODS AND SERVICES

- Technique involves issuing more than one invoice for the same international trade transaction.
  - Results in multiple payments for the same shipment of goods.

- Technique may involve the use of multiple financial institutions to make the additional payments.

- Unlike over- and under-invoicing, multiple invoicing schemes do not require the exporter or importer to misrepresent the price of the good or service.

OVER- AND UNDER-SHIPMENT OF GOODS AND SERVICES

- Technique involves the overstatement or understatement of the quantity of goods being shipped or services being provided.

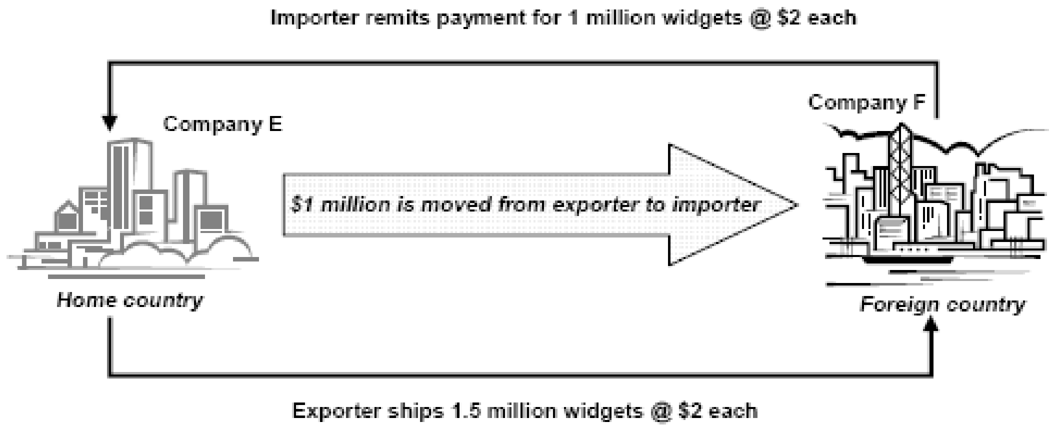
- Exporter may not ship any goods and instead collude with an importer to ensure that all shipping and customs documents associated with the "phantom shipment" are processed.

- Financial institutions may unknowingly be involved in the provision of trade financing for these phantom shipments.

OVER- AND UNDER-SHIPMENT OF GOODS AND SERVICES

Over- and Under-Shipment of Goods – An Example

Company E (a domestic exporter) sells 1 million widgets to Company F (a colluding foreign importer) at a price of $2 each, but ships 1.5 million widgets. Company F pays Company E for the goods by sending a wire transfer for $2 million. Company F then sells the widgets on the open market for $3 million and deposits the extra $1 million (the difference between the invoiced quantity and the actual quantity) into a bank account to be disbursed according to Company E's instructions.



Alternatively, Company G (a foreign exporter) sells 1 million widgets to Company H (a colluding domestic importer) at a price of $2 each, but only ships 500,000 widgets. Company H pays Company G for the goods by sending a wire transfer for $2 million. Company G then pays $1 million to its suppliers and deposits the remaining $1 million (the difference between the invoiced quantity and the actual quantity) into a bank account to be disbursed according to Company H's instructions.

FALSELY DESCRIBED GOODS AND SERVICES

- Technique involves the misrepresentation of the quality or type of good or service.
  - Example: Exporter may ship a relatively inexpensive good and falsely invoice it as a more expensive item or an entirely different item.

FALSELY DESCRIBED GOODS AND SERVICES

Falsely Described Goods – An Example

Company I (a domestic exporter) ships 1 million gold widgets worth $3 each to Company J (a colluding foreign importer), but invoices Company J for 1 million silver widgets worth $2 each. Company J pays Company I for the goods by sending a wire transfer for $2 million. Company J then sells the gold widgets on the open market for $3 million and deposits the extra $1 million (the difference between the invoice value and the actual value) into a bank account to be disbursed according to Company I's instructions.

Alternatively, Company K (a foreign exporter) ships 1 million bronze widgets worth $1 each to Company L (a colluding domestic importer), but invoices Company L for 1 million silver widgets worth $2 each. Company L pays Company K for the goods by sending a wire transfer of $2 million. Company K then pays $1 million to its suppliers and deposits the remaining $1 million (the difference between the invoiced value and the actual value) into a bank account to be disbursed according to Company L's instructions.

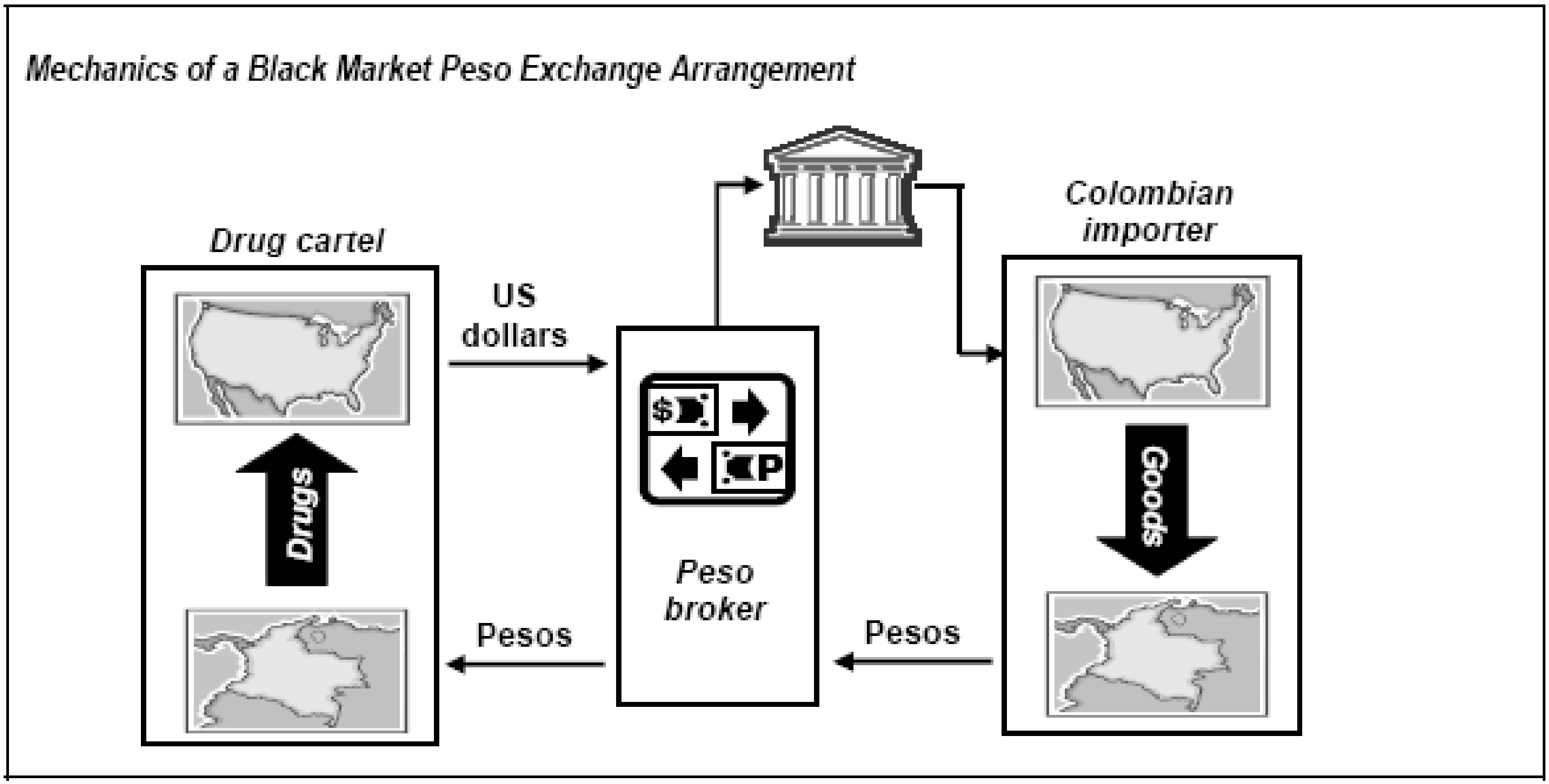
COMPLEX TRADE BASED MONEY LAUNDERING TECHNIQUES

- Terrorists and criminals usually layer techniques when laundering money.
  - Cash couriers and smurfing and over-invoicing to move illicit funds out of the country.

COMPLEX TECHNIQUE: BLACK MARKET PESO EXCHANGE

1. Drug cartel smuggles drugs into the U.S and sells for cash.
2. Drug cartel arranges to sell US dollars at a discount to a peso broker for Colombian pesos (or whatever the local currency may be).
3. Peso broker pays the drug cartel with pesos from his bank account in Colombia (no wire transfer, no bulk cash shipment, no other cross border remittance).
4. Peso broker structures the U.S. currency into the U.S. banking system.
5. Peso broker finds a Colombian importer that needs U.S. dollars to purchase goods from a U.S. exporter.
6. Peso broker arranges to pay the U.S. exporter on behalf of the Colombian importer for his U.S. bank account.
7. U.S. exporter ships the goods to Columbia.
8. Columbia importer sells the goods for pesos and repays the peso broker.

BLACK MARKET PESO EXCHANGE DIAGRAM



BLACK MARKET PESO EXCHANGE

- Combines different illegal activities
  - Drug Smuggling
  - Money laundering through financial system
  - Trade-based money laundering
- Drug cartel may act as its own peso broker and/or import business.
- Practice does not require collusion by importer and exporter.
  - Exporter may play a role in Black Market Peso Exchange scheme without knowing it.
- Scheme is not limited to Columbia pesos and may involve any currency and country.

CASE STUDY: YEMEN HONEY

- In October 2001, it was discovered that prices for honey exports to Yemen, the United Emirates, Kuwait and Saudi Arabia were significantly above the average price paid for honey exports elsewhere.

- Other Facts:
  - That month the U.S. Department of Treasury ordered financial institutions to freeze assets of three companies that sell honey in Yemen, based on reports that they might be part of Osama Bin Laden’s Al Qaeda network.

  - That month federal authorities arrested two men at JFK Airport on charges of trying to smuggle more than $100,000 in cash to Yemen in boxes of honey.

TRANSPORT CONCERNS

- In addition to money launderers/terrorists using trade to move value, the groups may also generate funds by transporting goods related to trade transactions.
  - Terrorists/money launderers are known to operate single vessels and entire fleets in order to generate funds and support their logistics operations, (e.g. Liberation Tigers of Tamil Eelam (LTTE)).
  - Vessels are owned by front companies.
  - Vessels transport mainly legitimate goods, also used for illegal shipments of arms, narcotics, humans, etc.
  - Tracking terrorist ownership and/or control of vessels is difficult given the multiple possibility for groups to obscure their true identities through weak vessel and/or corporate registration requirements.
  - Due to money launderers/terrorists infiltration of international logistics requires OFAC checking of not only the parties to the transaction but to the vessels as well.

TRANSPORT CONCERNS

Blocked vessels are being segregated into a separate section on the Master list of Specially Designated Nationals and Blocked Persons. Banks are now instructed to reject any funds transfer referencing a blocked vessel and must notify OFAC, via facsimile with a copy of the payment instructions, that funds have been returned to remitter due to the possible involvement of an SDN vessel in the underlying transaction. Banks must contact OFAC's Compliance Programs Division for further instructions should the name of an SDN vessel appear in shipping documents presented under a letter of credit or if noticed in a documentary collection. SDN vessels must themselves be physically blocked should they enter U.S. jurisdiction. Freight forwarders and shippers may not charter, book cargo on, or otherwise deal with SDN vessels.

ACECHILLY (Acechilly Navigation Co., Malta) (vessel) [CUBA]
ACEFROSTY (Acefrosty Shipping Co., Malta) (vessel) [CUBA]
ALAMINOS (f.k.a. RUBY ISLANDS) (P32C3) General Cargo 15,088DWT 8,909GRT Cyprus flag (Alaminos Shipping Co. Ltd.) (vessel) [CUBA]
ALEGRIA DE PIO (Naviera Maritima de Arosa, Spain) (vessel) [CUBA]
ANA I (a.k.a. SAND SWAN) (P3QG3) General Cargo 2,595DWT 1,116GRT Cyprus flag (Sand & Swan Navigation Co. Ltd.) (vessel) [CUBA]

WHY ARE TRADE BASED MONEY LAUNDERERS SUCCESSFUL?

- Banks are historically concerned with documents and not with goods provided or services performed.
  - The world of letters of credit is based on the delivery of agreed upon documents.

- Money launderers can invest years developing a pattern of international activity that lulls bankers to sleep.
  - This transaction is not suspicious because they have been doing it like this for years.

- Historically, bankers have felt that it is unreasonable for them to go beyond the documents presented.
  - Bankers have taken the view that they are merely financing the trade transaction.
  - Bankers do not assume responsibility for the existence or quality of the goods traded.
  - The trade financing system is based on documents.
  - WAKE UP! The world has changed…like it or not!

WHAT IS THE REGULATORY/LAW ENFORCEMENT RESPONSE TO TBML?

- Trade-based money laundering procedures included in FFIEC Manual.
  - Number of SARS is very small despite perception that Trade-based money laundering is common.
  - Low number of SARS suggests lack of training and awareness by financial institutions.

- FATF Report concluded that the international trade industry represents a serious terrorist financing and money laundering vulnerability.

TRADE TRANSPARENCY UNITS (TTUS)

- TTUs use technology to share and analyze trade data and uncover trade-based money laundering operations.

- Techniques include the detection and investigation of anomalies in international commerce that may be indicative of trade-based money laundering.

RISK MITIGATION

- Banks in the L/C process need to undertake varying degrees of due diligence depending on their role in the transaction.
- Due diligence should include gathering sufficient information on Applicants and Beneficiaries, including their identities, nature of business and sources of funding.
- Banks should have a thorough understanding of trade finance documentation.
- Documentation should be reviewed not only for compliance with the terms of the letter of credit, but also for anamolies or red flags that could indicate unusual or suspicious activity.
- If a SAR is required, the bank need not stop or discontinue the trade transaction unless it is required to comply with an OFAC sanction.

RISK MITIGATION

- Banks should monitor all names contained on SWIFT messages against OFAC lists.
- Documents commonly used for checking against the terms of the LC include:
  - Bills of Lading – Invoices Stating Quantities/Quality – Insurance – Certificates of Origin – Other Related Documents

RED FLAGS

- 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 in 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.

RED FLAGS

- The size of the shipment appears inconsistent with the scale of the exporter or importer's regular business activities.
- The type of commodity being shipped is designated a "high risk" for money laundering activities (e.g., high value, low volume goods).
- The type of commodity being shipped appears inconsistent with the exporter or importer's regular business activities.

RED FLAGS

- The shipment does not make economic sense.
- 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.
- The transaction involves the use of front or shell companies.

RED FLAGS

- Customers are conducting business in high-risk jurisdictions.
- Customers are shipping items through high-risk jurisdictions, including transit through non-cooperative countries.
- Customers are involved in potentially high-risk activities (e.g., weapons, chemicals, nuclear materials, etc.).

RED FLAGS

- Customers are involved in obvious over- and under-invoicing of goods and services.
- Customer and/or Issuing Bank submit excessively amended letters of credit without reasonable justification.
- Transactions are evidently designed to evade legal restrictions, including evasion of necessary government licensing requirements.

RED FLAGS

- A letter of credit with one or more of the following missing:
  - Name and address of the Applicant or Beneficiary
  - Name and address of the Issuing or Advising banks
  - Amount and type of currency
  - Sight or time draft to be drawn
  - Expiration date
  - Description of merchandise
  - Types and numbers of documents that must accompany the letter of credit

RED FLAGS

- An unsigned letter of credit

- Numerous inquiries by the Beneficiary regarding the LC’s issuance (a sense or urgency and/or angry complaints)

- Presentation of the LC or documents where the bank has no record of the credit’s existence

RED FLAGS

- Letter of credit opened by telex when the telex has not been tested with the receiving bank
- Letters of credit involving obscure ports and/or locations that cannot be contacted by telephone or telex

BANKER TOOLS

- Trade Research Institute (https://ustrade.fiu.edu/)
  - Provides member banks with trade data so that bankers may obtain the prices of goods for deals in which they are involved in providing financing.

WHEN TO SOUND THE ALARM

- For years, frontline personnel have asked to determine when a transaction becomes a “suspicious” transaction.

- Trade finance personnel are now tasked with the job of determining at what point to make a referral to their compliance officer.

- When does a transaction become a suspicious transaction!?

CONCLUSIONS

- Trade Based Money Laundering represents as increasingly important money laundering and terrorist financing vulnerability.
- As international trade continues to grow and the standards applied to other money laundering techniques become increasingly effective, the use of TBML channels can be expected to become increasingly attractive.
- TBML practices vary in complexity.
- Basic Schemes: Fraudulent trade practices such as under- and over-invoicing of receipts.
- Complicated Schemes: Integrate the basic schemes into a web of complex transactions that may also involve movement of value through the financial system (checks/wire transfers) and/or the physical movement of cash.
- The use of complex transactions obscures the money trail and complicates detection.

IS THE SKY FALLING?

- No. The vast majority of trade finance transactions and documentary transactions are bona fide.

- However, as alternate money laundering approaches are hardened, criminals and terrorists move to the lower hanging fruit.
  - As law enforcement/regulators continue to crack down on bulk smuggling and cash placement, trade-based money laundering becomes more popular.

QUESTIONS?