Trade finance fraud
When buyers and sellers act in collusion

by P. Mukundan, Director, ICC International Maritime Bureau

Banks get affected one way or the other whenever there is a trading fraud. If buyers defraud sellers or sellers defraud buyers, banks as the financiers of the victim often watch anxiously from the sidelines as attempts are made to recover the losses. These frauds, however, are usually limited to the value of the transaction and banks should, in theory at least, have other collateral to secure their exposure.

The greatest danger to the banks, though, is the fraud where buyers and sellers act in collusion from the outset to defraud the bank.

The ICC-International Maritime Bureau (IMB) has investigated numerous cases where banks have financed transactions which they believed to be genuine arms-length trade deals between the buyers and sellers. No effort was made to check whether the documents presented were genuine. Indeed there is no obligation under the UCP 500 for the banks to make such checks.

As the volume of the transactions increase, banks extend even better facilities to the buyers/sellers. The contribution of these traders to the fees earned by the documentary credit department of the bank become significant. As the bank perceives the client to be more important, the less likely it is that bank staff will examine the transactions with the care and detachment that might be prudent in the light of the sums advanced.

The collateral illusion

The IMB investigated a case where a bank had financed a chemical supplier from the UK for his shipments to buyers in Nigeria. A policy decision was taken by the bank not to continue to provide credit facilities for the trade to Nigeria.

In this case, the trader presented documents to the bank to show that he was now exporting the cargoes to Switzerland, against which the bank was happy to provide even better facilities than they had for the trade to Nigeria.

What the bank did not know was that the chemicals were still being exported to Nigeria, but false documents were presented to show that they were going to Switzerland. The chemicals would arrive in Nigeria, be sold in the local market and the proceeds would then find their way back into Switzerland in time to meet the deferred payment arrangements with London.

This ruse worked successfully for many years, until the bank holding the funds in Nigeria ceased operations. The money flow to Switzerland stopped and it was not possible to make the payments from Switzerland to the bank in London. It was then that the London bank began making

investigations through the IMB and found that for many years it had been financing a trade which had not existed.

The trade finance fraud of the decade

One of the most spectacular trade finance frauds in recent times concerned a metals trading and processing company based in the UAE. For the purposes of this article let us call this company LONECO. When the fraud was finally discovered and the persons behind LONECO disappeared, over USD 400 million had gone adrift. Some estimates place the losses much higher. The IMB investigated over 900 transactions and probably has the best overall picture of this fraud. The victims were 26 international banks in the Middle East and Europe, some of which were considered to have highly sophisticated trade finance operations.

LONECO relied on the fact that once it gained the confidence of banks, they were unlikely to question transactions which it brought to them. Over the years it developed a network of buyers, sellers and NVOCCs (Non-Vessel Owning Common Carriers) who produced documents indicating that they were doing substantial trade. The diversity of the companies helped to give the illusion credibility.

The banks granted substantial credit facilities to LONECO for its trade. LONECO shipped low-value lead ingots from Sweden and tin ingots from Malaysia/Singapore to Jebel Ali. NVOCCs controlled by LONECO produced bills of lading stating that the cargo loaded was lead silver alloy, tantalum concentrate, indium alloy and other high-value metals. In many cases for each genuine low-value shipment, four different sets of fraudulent bills of lading were produced which went through four different banking channels. Each banking channel financed LONECO for the purportedly "high-value cargoes". It was not uncommon for a transaction worth USD 40,000 to be leveraged through false documentation to raise finance worth USD 400,000 from different banks, each unaware that similar documents in respect of the same containers were being presented to other banks.

The LONECO case was unusual because of the size of the fraud. The IMB has come across similar schemes in many other instances involving smaller sums. This *modus operandi*, it would appear, is not new to the trading community.

The North African mint

A company with widely diversified interests in shipping, trading, construction and tourism in North Africa had a substantial trading portfolio with a European Bank. When the trade finance department of this bank became members of the IMB, routine and random checks were made to verify bills of lading presented to it. The checks identified two of these as false. The bank advised that these bills of lading had been presented by one of their prime customers and a request was made for the IMB to re-

check the documents.
The checks confirmed that the documents were false. Indeed, further enquiries into past transactions entered into by this company indicated that a substantial percentage of the documents presented over the previous two years were false. The investigations did not confirm exactly what this company was up to, but it was clear that it was using the documentary credit system for purposes other than what it had declared to the bank. The question arose: why was a substantial company with a long-standing banking relationship systematically presenting false trade finance documents?
Because of the countries involved, the possibility of money laundering could not be ignored.
It has been the IMB's experience that many companies having a large part of their assets in soft local currencies often use the trade finance system to convert their local currencies into harder currencies abroad. The volume of these fraudulent transactions often increases when the local currencies are under pressure. Because trade finance can release large amounts of funds, almost entirely against documents, it is a useful mechanism to convert dirty money into clean, documented funds in a destination far from where the letter of credit was opened. This is a tried and tested cycle of the money wash. Banks cannot afford the reputation risk of becoming involved in these schemes.

How should banks respond?
The documentary credit system can be used as a cover for many activities, which the banks are led to believe are trade-based.
It is accepted that under UCP 500 banks have no duty to look beyond the face of the documents. This is the only practical way for the documentary credit system to work. It is vital that the system continue to function. After all, the vast majority of trade transactions are conducted successfully in this way between honest buyers and sellers.
Nonetheless, in light of recent cases, it is in banks' own interests to ensure that they know precisely what activities their clients are asking them to finance. They can do this by making independent checks into the transactions, i.e. by authenticating the bills of lading and other key documents presented under the documentary credit system.Only through these independent checks can banks be sure they are financing what their clients are declaring to them. In fact, this is the only way some of the early warning signs of a long-term fraud against the bank will be detected.

Banks often believe that the bill of lading consigned to them represents a piece of collateral within the trade transaction. The feeling is that, if all else fails, with the bill of lading they will be able to get their hands on the cargo and recover some of their losses. But if that document is itself false, they have no collateral. They may be financing a transaction worth millions of dollars based upon a non-existent cargo.

It's clear that when these companies go down, it is the bank that loses. Hence, the necessity by a bank to check, for its own internal purposes, whether or not documents presented are genuine.
We recommend that the banks pick up at random bills of lading presented to them from amongst their good and not so good, large and small, old and new clients and have the B/Ls checked at regular intervals. The checks are aimed not so much at preventing transaction-specific frauds but at gaining intelligence about long-term frauds. Such checks are routinely provided by the IMB to its banking members.
If banks fail to institute checks, they may find one day that their exposure to some fraudulent companies has grown to such substantial amounts that it can significantly impact upon operations of the bank itself. Case in point: one bank has taken a hit of over USD 200 million in a massive fraud which involved fraudulent trade finance transactions.

Conclusions

To repeat: the greatest fraud risk to banks in trade finance occurs when buyers and sellers act in collusion with the bank as the target. These are long-term frauds often perpetrated by clients who have gained the confidence of the banks.
This reality changes the traditional risk paradigm of banks. For their own internal security purposes they need to have systems in place which ensure they are not financing spurious transactions. Such checks, if done properly, will not dilute their obligations under UCP 500.

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