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Mitigate trade financing risks with proper documentation, analysis

As evidence emerges that international trade is being used to launder money and finance terrorism, banks must pay closer attention to their trade financing activities and learn to manage those risks.

The U.S. Federal Financial Institutions Examination Council Bank Secrecy Act/ Anti-Money Laundering Examination Manual states that banks "should require a thorough review of all applicable trade documentation to enable the bank to monitor and report unusual and suspicious activity" and "give greater scrutiny to obvious over- or under-pricing of goods and services."

Complying with the exam manual is easier said than done. Banks can climb over that learning curve and detect trade-based financial crime by analyzing suspicious international trade two different ways and by scrutinizing trade documentation.

Analyze transaction character

Character-based analysis requires banks to evaluate non-price characteristics of trade-financing transactions, such as the risks of the product, the country of import or export and information gathered using existing know-your-customer policies. However, such analysis cannot determine the quantifiable risk of a particular transaction.

Analyze transaction price

Transaction-based analysis, on the other hand, enables institutions to detect trade-based money laundering by evaluating the price of the products being imported or exported.

One transaction analysis technique involves a time-series analysis to evaluate the specific transaction price and compare it with the client's historical import or export prices for the same product. However, this technique would not indicate money laundering if the customer undervalued or overvalued the product in past transactions. For example, a \$10 export transaction for a kitchen stove would not stand out if the customer had been exporting kitchen stoves at that price for months or years.

It's imperative that banks also conduct a cross-sectional price analysis by comparing the price of the financed product in the letter of credit with its market value. It's easy to check the market prices of such products as wheat, soybeans, corn, gold or silver – anything traded on exchanges such as the Mercantile Exchange or the Chicago Board of Trade can be found in the Wall Street Journal.

Since most of the products imported and exported to and from the United States are not traded on organized exchanges, there is no place to secure the market prices of items such as ketchup, bicycles, soccer balls, television sets, pillow cases, plastic buckets or tweezers. Banks can determine the price ranges of those and other products they finance by subscribing to the U.S. Commerce Department's merchandise trade database, which includes data about all imports and exports into and out of the United States.

All U.S. imports and exports are classified by 10-digit harmonized codes, which must be documented on U.S. Customs forms 7501 (import summary) and 7525 (shippers export declaration). This coding system is used on a global scale and is the only available standardized set of product descriptions and prices, so importers and exporters do know the codes of the products they receive or ship.

Beware of misleading documents

The product information contained in invoices, manifests and bills of lading is often inaccurate or misleading. All international trade transactions must use metric measurements, such as liters, kilograms and meters. Many invoices instead measure products in terms of gallons, pounds or yards and include inaccurate information about the quantities of products involved in the transaction. For example, an invoice stating the square feet of granite tile being imported is worthless since it is priced by the ton.

Invoices also tend to contain inaccurate product descriptions. For example, an invoice to import 500 kilograms of frozen shrimp does not provide the information needed to analyze its market value because there are nine different U.S. harmonized codes for frozen shrimp imports of different sizes. That code is vital for determining whether the transaction indicates tradebased money laundering.

Ask for accurate documentation

Banks need to monitor the prices of the products they finance, and must require the importers and exporters to provide them with the transaction information in Customs forms 7501 or 7525, including the 10-digit harmonized codes, accurate product descriptions, quantities and units of measure, the dollar value of the transaction and the country of import or export. Banks need that data to determine if they are financing trade-based money laundering transactions.

In the same way that banks won't cash checks without identification or provide mortgages without the address and description of the properties, they shouldn't finance trade transactions without the information in those documents. The solution to the documentation problem is simple: just ask for it. Those who don't could facilitate money laundering.

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