



Circulars

19 Jul 1999

Fraud cases relating to letter of credit

Our Ref.: B1/15C

19 July 1999

The Chief Executive
All authorized institutions

Dear Sir/Madam,

Fraud cases relating to letter of credit

In view of the significant number of letter of credit ("L/C") related fraud cases received by the Commercial Crime Bureau ("CCB"), I am writing to draw your attention to the schemes commonly used to deceive banks and their trade customers and the precautionary measures which may help prevent such frauds.

According to CCB's statistics, it has received reports on 45 L/C related fraud cases since January 1998, involving a total of \$1.2 billion. These cases involved bills drawn under L/Cs negotiated with authorized institutions ("AIs") in Hong Kong using false negotiation documents. While most of the L/Cs concerned were issued by banks on the Mainland, the number of local L/Cs is also quite significant. In addition, there are cases involving L/C kiting (see below). Details of these schemes are given below.

Use of false negotiation documents

1. The culprit lured unwary buyers to open L/Cs (local L/Cs on some occasions) to buy goods from him by offering very attractive terms, e.g. below market pricing,
2. or

The culprit ('company A') requested another company ("company B") to apply for L/Cs on its behalf from a bank on the Mainland. Company B received a certain amount as commission. In some cases, A and B were both companies on the Mainland and Company B was actually an associate of Company A.

3. The culprit or an associate of the culprit, as the beneficiary of the L/C, then submitted false negotiation documents to an AI in Hong Kong for discounting.
4. The culprit and its associates disappeared after obtaining the proceeds from the AI in Hong Kong.
5. The buyer and the negotiating bank later on discovered that the goods did not exist.

L/C kiting

1. The culprit ('Company A') first obtained a L/C credit line from an AI.
2. Bogus transactions were then created by trading with Company B (an associate of Company A) posing as a supplier and the AI was asked to issue a L/C to Company B as the beneficiary.

3. Company B then discounted the documents with its bank and used the proceeds to help Company A to settle the L/C when it fell due. In some cases, the proceeds from discounting the documents of a subsequent L/C were used to settle the liabilities under a previous L/C.
4. Company A used the concocted business volume and the good track record to justify an increase in L/C credit line.
5. More bogus transactions were created and more L/Cs were opened.
6. Company B discounted all the documents under the L/Cs with its banks and disappeared suddenly together with Company A.

Preventive measures

While some of the reported cases are still under investigation, CCB observes that some of the fraud cases mentioned above could have been avoided, or at least the scale of the problem could be significantly reduced, if the following preventive measures were adopted by Als concerned.

1. In the credit assessment and approval process, Als should pay particular attention to the nature and history of the customer's business, including any recent change in the ownership and management of the company, major trading partners and its trading pattern.
2. Credit lines should be approved having regard to, among other factors, the business need of the borrower, the value of underlying collateral and proven track record of repayment. Request for drastic increase in credit facilities within a short period of time should be carefully examined.
3. Drastic increase in L/C outstanding balances should be closely monitored. It would be useful to visit the borrower's office or factory to ensure that business and production are normal and can cope with the increased volume.
4. Als should avoid entering into L/C transactions with abnormal terms, e.g. in cases where the nature or volume of goods is unusual, the usance period of bills is unreasonably long, and documents required for payment are exceptionally simple so that false documents could be created easily.
5. In handling the L/C documentation, negotiating banks should ensure that L/Cs presented have been authenticated by the advising bank. Where necessary, they should confirm the authenticity of the L/C with the issuing bank. It should also review carefully the terms of L/Cs and any subsequent amendments and where necessary, follow up with the issuing bank. For L/Cs of substantial amount or in case of doubt, shipping documents should be authenticated before negotiation. As far as possible spot checks should be arranged on suppliers and inspection certificates should be obtained from independent surveyors. These steps could help ensure the authenticity of L/Cs and the shipping documents.
6. If the beneficiary of the L/C is not a well-established company or the bank is not familiar with the beneficiary, extreme care should be taken to discount the relevant bills. If not sure of the background of the beneficiary, Als should avoid negotiating the documents but to send them to the L/C issuing bank for collection only.

The above measures are by no means exhaustive. Against the above background, the HKMA expects that all Als should review their own internal procedures and practices in handling L/C transactions. The aim is to ensure that adequate internal controls are established and enforced rigorously to prevent loss from fraud.

Co-operation with the CCB

The HKMA expects institutions to report any suspicious fraud cases to CCB as soon as possible. It also expects institutions to render as much assistance as possible to facilitate CCB's investigation. This would help to minimise losses of AIs from frauds and enhance the security of the banking system.

Yours faithfully,

Y K Choi
Executive Director
(Banking Supervision)

c.c Commercial Crime Bureau (Attn: Mr Ng Sai-kuen, Shelton,
 Senior Superintendent of Police)
 Chairman, HKAB
 Chairman, DTC Association

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