

# Safety and Soundness

Capital  
Adequacy  
(C)

Asset  
Quality  
(A)

Management  
(M)

Earnings  
(E)

Liquidity  
(L)

Sensitivity to  
Market Risk  
(S)

Other  
Activities  
(O)

## Trade Finance and Services

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# Introduction

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The Office of the Comptroller of the Currency's (OCC) *Comptroller's Handbook* booklet, "Trade Finance and Services," is prepared for use by OCC examiners in connection with their examination and supervision of national banks, federal savings associations, and federal branches and agencies of foreign banking organizations (collectively, banks). Each bank is different and may present specific issues. Accordingly, examiners should apply the information in this booklet in a manner consistent with each bank's individual circumstances. When it is necessary to distinguish between them, national banks<sup>1</sup> and federal savings associations (FSA) are referred to separately. This booklet addresses international trade finance and services activities. These activities<sup>2</sup> include letters of credit, guarantees, acceptances, open account financing,<sup>3</sup> other specialized trade financing, financial supply chain solutions, prepayment, advising, trade collections, bank-to-bank reimbursement services, insourcing/outsourcing trade processing, and hedging services. (Updated October 15, 2018)

## Overview

International trade, in terms of export value in nominal terms, has increased exponentially over the last three decades. Lower trade barriers, supported by multilateral trade negotiations and regional trade agreements, have helped fuel this growth. Also facilitating the growth in international trade are a broader range of invoicing currency<sup>4</sup> and advances in technology.

The growth also is affecting U.S. exports and imports, which have been rising. At the same time, markets have become more efficient, competition has increased, and company profit margins have been under pressure. In response, businesses conducting international trade have been seeking more cost-effective trade finance solutions, such as open account financing, more effective use of the financial supply chain, and the outsourcing of back-office trade processing services. These changes have created business opportunities, as well new risks, for U.S. banks.

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<sup>1</sup> References to "national banks" throughout this booklet generally also apply to federal branches and agencies of foreign banking organizations unless otherwise specified. Refer to 12 USC 3102(b) and the "Federal Branches and Agencies Supervision" booklet of the *Comptroller's Handbook* for more information regarding applicability of laws, regulations, and guidance to federal branches and agencies.

<sup>2</sup> The activities listed in this booklet are not a comprehensive list. These are the primary activities that examiners may encounter during their examination.

<sup>3</sup> In an open account transaction, the buyer and seller agree on payment on a specified date without a negotiable instrument, such as a draft or acceptance, evidencing the obligation. In most cases, the shipping documents are sent directly to the buyer rather than through a bank.

<sup>4</sup> While the U.S. dollar retains its dominant role in financing international trade, the euro has emerged as a major currency for trade invoicing. In recent years, the creation of an offshore market for the renminbi has prompted an appetite in the market for local currency financing of trade with China.

Globalization has changed the relationship between international buyers (importers) and sellers (exporters) of goods and services. Many emerging markets have become more open, and purchasing from these markets is more common. In these highly competitive markets where suppliers often offer similar goods and prices, buyers' negotiating power increases. The traditional terms of payment (for example, commercial documentary letters of credit) have, to some extent, been replaced by terms more favorable to buyers. Some regular buyers are requesting that trade be conducted on an open account basis, which is less costly and cumbersome than commercial documentary letters of credit.

Banks facilitate international trade by mitigating or absorbing some of the risk that would otherwise be borne by the importer or exporter. For example, an importer that pays for goods before receiving them risks that the exporter will not ship them. There is further risk to the importer that goods shipped do not conform to agreed-upon terms or that documentary flaws delay delivery of goods. Likewise, an exporter that ships goods before receiving payment is at risk. While some exporters may decide to accept that risk by relying on past relationships or credit assessments performed internally or by rating firms, others are uncomfortable absorbing that risk directly.

Banks offer products that help the importers and exporters mitigate risks, including credit, country, foreign exchange, interest rate, and documentary risks. Traditional trade products such as commercial documentary letters of credit, banker's acceptances, and standby letters of credit provide for the transfer of risk from the importer and exporter to the bank, for a fee. While these products remain central to the trade business of banks, the scope of trade offerings, especially at global banks, is broadening. For example, banks are offering purchase order financing and accounts receivable financing to clients trading on open accounts. With advances in Internet-based technologies, an increasing number of banks are offering electronic platforms that combine services such as transaction initiation, document preparation, purchase order management, and payments as an adjunct to a wider trade finance relationship with the client.

Each bank chooses how to organize its trade activities. Global banks are likely to have separately identified lines of business for trade finance and trade services that offer the full array of products described in this booklet, as well as others. Other banks may have designated international departments that include portions of trade finance or trade services described in this booklet. Still others may use third parties for trade activities, issuing only a limited number of letters of credit through their commercial credit departments.

Some smaller banks may rely on foreign correspondent banking relationships to facilitate the trade activities required by their clients. Banks maintain correspondent relationships with other banks to provide services that can be performed more economically or efficiently because of the other bank's size, expertise in a specific line of business, or geographic location. Some banks have built on this relationship, providing an unsecured, revolving line of credit to the foreign bank that is then recycled as an operating loan to a local importer or exporter. In this arrangement, the credit risk exposure is that of the correspondent bank, not the local importer or exporter.

Regardless of how the bank organizes its trade activities, the OCC expects each bank to have governance structures and a risk control framework that are suitable to the size and complexity of the trade activities that the bank provides to clients.

One of the more significant challenges to the smooth operation of international trade has been the differences in local laws and use of terms among countries and regions. Although banks should still have comprehensive country compliance matrices to facilitate ongoing compliance, the International Chamber of Commerce (ICC) has developed a standard set of terms and definitions that have been incorporated into contracts and regulations globally. Despite the common trade language, however, disputes between parties still arise. The ICC offers dispute resolution services, including arbitration and mediation, at a cost typically much lower to all parties than litigation and usually in much shorter time frames. (Updated October 15, 2018)

## Trade Finance

As noted previously, banks have developed business lines designed to help importers and exporters mitigate the credit risk inherent in the purchase and shipment of goods, largely by using commercial documentary letters of credit. Banks also have developed programs designed to finance the acquisition of goods by importers or to finance their clients' suppliers. Small suppliers can have difficulty obtaining the capital needed to support their businesses, particularly when experiencing rapid growth. Programs such as supply chain financing and receivables financing can provide a source of working capital for those firms.

Although short-term, self-liquidating loans compose most trade finance, medium-term loans (one to five years) and long-term loans (more than five years) may finance the import and export of capital goods such as machinery, equipment, and aircraft. Aside from the contract terms, the structure used in a specific international trade transaction usually reflects the depth of the participants' business relationship, the countries involved, and the level of competition in the market.

The level of credit risk that a bank is willing to accept with an individual client generally is established on a bank-wide level, with risk exposure allocated to different lines of business, regardless of whether the bank has a distinct trade finance department, has an international department, or incorporates trade finance into its commercial operations. When a bank has a separately identified trade business line, that department generally is responsible for structuring the trade credit, monitoring the portfolio, and managing the credit risk. Smaller banks may incorporate the management of trade credit into the commercial credit department. Although trade finance historically has been a low credit risk activity because of the short-term nature of the portfolio or government guarantees, the OCC expects effective credit risk management of trade finance exposure.

This section outlines the trade finance instruments that banks may offer to finance their clients' international trade transactions.

## Letters of Credit

Many banks, regardless of size or complexity, issue letters of credit on behalf of their clients. A letter of credit gives the beneficiary increased assurance that promised payments or performance will be fulfilled. In essence, the bank issuing the letter of credit (issuing bank) is substituting its creditworthiness for that of its client.

There are two broad types of letters of credit that banks use to facilitate trade finance: commercial documentary letters of credit and standby letters of credit.

### Commercial Documentary Letters of Credit

The commercial documentary letter of credit<sup>5</sup> is commonly used to finance a commercial contract for the shipment of goods from seller to buyer. This versatile instrument may be used in nearly every type of trade finance transaction and provides for prompt payment to the exporter when the goods are shipped and conforming documents are presented to the bank. According to the Uniform Commercial Code (UCC), all letters of credit must be issued

- in favor of a specific beneficiary (the exporter);
- for a specific amount of money;
- in a form clearly stating how payment to the beneficiary is to be made and under what conditions; and
- with a specific expiration date.

Individual banks may use terms such as “import letter of credit” and “export letter of credit,” but these terms are not separate products. They reflect the different positions of an importer and exporter in the use of the same letter of credit for a transaction.

To the importer, the letter of credit allows the issuing bank to substitute its creditworthiness for that of its client, the importer. At a client’s request, the issuing bank pays stated sums of money to the exporters against stipulated documents transferring ownership of the goods. A letter of credit does not eliminate the risk of fraud or deception by an unscrupulous exporter against an importer, because the bank deals only in documents and does not inspect the goods themselves.

If the issuing bank is not local to the exporter or otherwise acceptable to the exporter, the exporter may insist that the issuing bank obtain confirmation of credit from a bank local to or acceptable to the exporter. The confirming bank then becomes directly obligated to the exporter as if it were an issuing bank and has rights, obligations, and risks (for example, country) with respect to the issuing bank as if the issuing bank were a letter of credit applicant.

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<sup>5</sup> The term is also known as commercial letters of credit, documentary letters of credit, documentary credit, or simply letters of credit. In trade, when the term “letters of credit” is used, it is generally understood that it refers to commercial letters of credit. The term does not include standby letters of credit, which are referred to as standby.

The success of a commercial letter of credit transaction depends heavily on documentation and resolution of document discrepancies. A single transaction requires many different types of documents, and failure to obtain conforming documents or to resolve document discrepancies, especially material errors, may cause the bank to lose its protection and rights and suffer financial loss.

Payments under a commercial letter of credit do not necessarily lead to an extension of credit. The bank prearranges with the client the method by which the letter of credit will be funded, normally by a debit to an existing bank account or by using a preapproved credit facility.

For additional information about commercial letters of credit and the process flow relating to the issuance of commercial letters of credit, see appendix A and appendix C, respectively. For the various categories of commercial letters of credit, refer to the glossary for descriptions.

### **Standby Letters of Credit**

Standby letters of credit are common bank instruments that also may be used in trade finance. For example, a bank issues a standby letter of credit on behalf of a client involved in a long-term project. Normally that project stipulates that the client adhere to certain performance measures. The standby letter of credit is used to ensure payment to the beneficiary if the bank's client fails to perform as contractually agreed. A standby letter of credit is not used to finance the purchase or shipment of goods. (Updated October 15, 2018)

### **Commercial Letters of Credit vs. Standby Letters of Credit**

There are many differences between commercial letters of credit and standby letters of credit. Commercial letters of credit are short-term payment instruments for financing international trade, while standby letters of credit can be written for any purpose or term.

Under all letters of credit, the banker expects the customer to be financially able to meet its commitments. A banker's payment under a commercial letter of credit for the customer's account is usually reimbursed immediately by the customer and does not become a loan. The bank makes payment on a standby letter of credit, however, only when the customer has defaulted on its primary obligation and probably will be unable to reimburse the bank immediately.

A standby letter of credit transaction holds more potential risk for the issuing bank than does a commercial letter of credit. Unless the transaction is fully secured, the issuer of a standby letter of credit typically retains nothing of value to protect it against loss, whereas a commercial letter of credit provides the bank with title to the goods being shipped. (Updated October 15, 2018)



## Governing Rules and Practices

The rules governing letters of credit transactions in the United States derive from article 5 of the UCC, “Letters of Credit,” and the Uniform Customs and Practice for Documentary Credits (UCP), published by the ICC. Each U.S. state incorporates the UCC into its statutory scheme, but the states differ in how much of the UCC they incorporate. Thus, state laws for letters of credit vary, as do the laws of foreign countries, and it is important for bank personnel to be knowledgeable about applicable laws. (Updated October 15, 2018)

The UCP does not carry the force of law but instead is a set of generally accepted ground rules developed over the years for letter of credit transactions. The rules are accepted by the vast majority of commercial letter of credit issuers. For the UCP rules to apply, the commercial letter of credit must expressly indicate that it is subject to the rules. The rules are then contractually binding on all parties to the commercial letter of credit unless its terms and conditions expressly exclude or modify a rule.

The generally accepted international practices governing standby letters of credit are contained in the UCP and the International Standby Practices, 1998 edition (ISP98), also published by the ICC. ISP98 provides separate rules for standby letters of credit that are more specialized than those outlined in the UCP.

For information on accounting practices for letters of credit, see appendix G.

## Guarantees

National banks may issue guarantees and sureties in certain circumstances, including when the bank has a substantial interest in the performance of the transaction involved or the bank has a segregated deposit sufficient in amount to cover its potential liability. Additionally, national banks may guarantee obligations of their customers, subsidiaries, or affiliates that are financial in character, provided the amount of the bank’s financial obligation is reasonably determinable and otherwise consistent with applicable law. Under certain circumstances, foreign branches of national banks may exercise powers exercised by banks in the host country, including guarantees. Like standby letters of credit, guarantees represent the undertaking of the bank, as issuing bank, to make payment to a third party on behalf of a client upon the occurrence of a predefined event. Normally, the client agrees to reimburse the bank for amounts paid out under the guarantee. FSAs, subject to certain conditions, may enter into sureties and guarantees. For additional information on guarantees, see appendix D. (Updated October 15, 2018)

## Acceptances

An acceptance is an unqualified promise of the acceptor to pay the face amount of the draft at its maturity. When an institution such as a commercial bank or nonbank institution has “accepted” the draft, the word “accepted” is written or stamped on the face of the draft, and the draft has the following additional information: name of the institution, signature of officer or officers, date, possible nature of underlying transaction, and other information depending

on the circumstances. Most acceptances cover a commercial transaction that is considered to be self-liquidating in nature, such as a commercial letter of credit.

There are two types of acceptances: banker's acceptances and trade acceptances. Although acceptances can be created in any currency, in practice, most are denominated in major world currencies.

### **Banker's Acceptances**

A banker's acceptance is created when a time draft drawn on a bank (usually to finance the shipment or temporary storage of goods) is stamped "accepted" by that bank. By accepting the draft, the bank makes an unconditional promise to pay the holder of the draft a stated amount at a specified date. Banker's acceptances are a potential source of financing for an exporter, as there is a readily available market to sell the acceptance at a discount to face value. A banker's acceptance remains a common financial instrument in trade finance activities.

A banker's acceptance must appear on the bank's financial statement as a liability and an asset. See appendix G for details on the accounting practices for banker's acceptance.

### **Trade Acceptances**

A trade acceptance is a time draft that has been "accepted" by a nonbank institution, such as an importer. When the acceptance matures, the importer pays the exporter the face amount of the acceptance. A trade acceptance is created through the documents against acceptance collection method (see this booklet's "Trade Collections" section for additional information about documents against acceptance). Unlike banker's acceptances, there is no ready market for trade acceptances.

### **Financing Through Discounting Banker's Acceptances**

In the United States, if a banker's acceptance conforms to the requirements of section 13 of the Federal Reserve Act of 1913, as amended (termed an "eligible" banker's acceptance), the acceptance can readily be sold as long as the credit quality of the accepting bank has not changed. Banker's acceptances have liquidity because dealers have made an active secondary market in those that are eligible for purchase by the Federal Reserve Bank. For additional information about banker's acceptances, see appendix B.

## **Open Account Financing**

Parties to a trade transaction may use open account shipments when the buyer has a strong credit history and is well known to the seller. The buyer may also be able to demand open account sales when there are several sources from which to obtain the seller's product or when open account is the norm in the buyer's market. Open account trades involve no bills of exchange or drafts as trading documents. There is no bank acting as the intermediary as in the case of commercial letters of credit. There is no robust multilateral legal framework to

govern contractual and payment obligations. In short, in open account trades, the seller assumes all risks.

Although banks are not direct parties in open account transactions between buyers and sellers, they may, based on their relationship with either the buyer or seller, take the role of financing the seller by providing purchase order financing or accounts receivable financing. Examiners should review each product or transaction to properly identify and evaluate the repayment risks. For guidance, examiners should consult the “Asset-Based Lending” booklet of the *Comptroller’s Handbook*. (Updated October 15, 2018)

## Purchase Order Financing

The need for purchase order financing<sup>6</sup> may arise from the length of time it takes to go from order to production to delivery and payment of goods. The importer or exporter may approach the bank to provide financing to the exporter based on the purchase order placed by the importer. In this form of pre-export financing, the bank assumes the exporter’s production of goods and the importer’s repayment risks. It is important to identify the relationship between the importer and exporter, the products to be exported, and the financial strength of the importer if the bank’s relationship is with the exporter.

## Accounts Receivable Financing

A bank may enter into accounts receivable financing<sup>7</sup> with an exporter based on an existing relationship with the importer. In this arrangement, the exporter generally is a small supplier and the importer is a large corporation, and the bank may already be providing payable settlement services to the importer. The risk to the bank lies with the importer. This form of financing allows the exporter to obtain an early payment from the bank at an interest rate commensurate with the importer’s credit standing. The advances to the exporter are discounted at a percentage of outstanding sales invoices. A benefit to the importer is that it may be able to negotiate favorable purchasing terms with the exporter.

Conversely, the bank may have its primary relationship with the exporter and structure the transaction to finance its receivables at a discount. Foreign receivables have credit, legal, foreign currency, and country risks that can disrupt payments. For protection, the bank may require a commercial credit insurance policy on the importer carrying minimum deductibles when providing financing. The bank may either purchase the insurance or require the exporter to buy the insurance. Banks buying the insurance policy should have the resources to monitor compliance with insurance requirements. While credit insurance provides protection against loss, it does not cover dispute risk. The bank should have processes in place to properly manage the potential dilution risk arising from disputes. (Updated October 15, 2018)

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<sup>6</sup> Purchase order financing is also referred to as vendor financing.

<sup>7</sup> Accounts receivable financing is also referred to as invoice financing or invoice discounting.

The features of these types of financing vary among banks. Examiners should review the product to properly identify and evaluate the risks.

## Export Credit Programs

Export credit agencies are government or quasi-government entities that were developed to help increase their country's exports by assuming all or part of the credit risk involved in a related lending program. In some instances, the agency may also provide coverage for political risk. These agencies generally have programs to guarantee repayment of an extension of credit designed to support the export of goods by companies of all sizes, including capital goods or goods needed to support infrastructure development. For example, the Export-Import Bank of the United States (Ex-Im Bank) may guarantee the financing of aircraft exported from the United States to a developing country, guaranteeing up to 100 percent of the principal and interest of the covered loan. Most other developed countries have similar agencies, with guarantees typically ranging from 80 percent to 100 percent.

Despite the agency guarantee, these lending programs are not without risk. Credit risk remains for any portion of the loan not covered by a guarantee. Loan terms for capital goods may be longer than for other trade finance programs, ranging up to 15 years. Collateral, if any, may be difficult to locate, repossess, and liquidate. Each loan structure may include conditions or covenants that if not fully met may nullify the coverage of the guarantee. As with any extension of credit, the financial condition of the borrower and its ability to repay the loan should be fully evaluated. In addition, the financial condition of the country supporting the agency guaranteeing the loan should be considered. Banks should have systems in place to include these guarantee programs when they aggregate country risk exposure. (Updated October 15, 2018)

A variety of products and services other than loans may be included in a bank's export credit program. While some, such as advisory and arrangement services, may be managed by the trade finance area, others are better managed outside of trade finance. For example, most trade finance departments do not have the expertise to manage capital market activities such as hedging interest rate risk, foreign exchange, and commodity hedging programs.

For examples of U.S. government and multilateral agencies that provide export guarantees or insurance, see appendix F.

## Other Specialized Trade Financing

Other specialized trade financing includes factoring, forfaiting, and commodity trade financing. These types of financing require specialized knowledge and prudent risk management frameworks. Therefore, these types of specialized financing are generally the province of larger banks with dedicated units or staffs. Examiners should consult the "Accounts Receivable and Inventory Financing" and "Commercial Loans" booklets of the *Comptroller's Handbook* for additional guidance.

## Factoring

One challenge exporters face is obtaining sufficient capital to meet client demands for goods, particularly if the exporter is experiencing significant growth. Factoring is an arrangement in which a company shortens its cash cycle by selling its accounts receivable, traditionally without recourse, to a third party known as a factor. A factor assumes the full risk of collection, including credit losses. There are two basic types of factoring: (1) discount factoring, in which the factor discounts the receivables before the maturity date, and (2) maturity factoring, in which the factor pays the client the purchase price of the factored accounts at maturity. Factors frequently perform all servicing functions in connection with accounts receivable, in which case the buyers (importers in this case) are notified to remit payments directly to the factor. Because the factor takes on credit risk to the importers who owe the exporter, it is important that the factor fully understands the terms and associated credit risk.

Although banks can be factors, most factoring is done by nonbanks or companies. When a bank purchases domestic invoices from an exporter in another country, the bank should thoroughly assess the foreign country risk and the export company's financial condition and reputation. The foreign exporter's ability to deliver goods that fully conform to the terms of the purchase order is key; otherwise, disputes with the importer may arise that threaten the timely payment of the account receivable. Even if the bank obtains a commercial credit insurance policy, dispute risk is not covered. (Updated October 15, 2018)

## Forfaiting

Forfaiting, similar to factoring, is a type of nonrecourse financing of receivables. While a factor normally purchases a company's short-term receivables, a forfaiting bank purchases notes that are medium- to long-term receivables. The forfaiting bank has no recourse to the seller of the goods but gets the notes at a substantial discount in exchange for cash. Usually these transactions are endorsed by, or receive an "aval" or guarantee from, a foreign bank. Forfaiting is quite widely used in Europe and is gaining acceptance in Asia.

Forfaiting presents all of the risks associated with factoring, along with the risks associated with the long-term nature of purchased receivables. The examiner should review the bank's forfaiting activities carefully to determine whether long-term receivables have been purchased from countries prone to political or economic turmoil and the resulting fluctuations in exchange rates. In addition, the examiner should determine whether the forfaiting bank has verified the aval and determine that the bank in question has indeed guaranteed the transaction. The examiner also should analyze the credit standing of the foreign bank. (Updated October 15, 2018)

## Commodity Trade Financing

Commodity trading is a low-margin, volume-driven business. Commodity traders range from large, global, vertically integrated public or privately held firms engaged in producing, processing, and marketing commodities to smaller privately held companies involved solely

in buying and selling commodities. Commodities traded include energy (e.g., oil and gasoline), metal (e.g., silver, copper, zinc, nickel, and aluminum), and agricultural (e.g., wheat, soybeans, corn, coffee, cocoa, sugar, and cotton) products. Banks providing commodity trade financing are usually larger institutions with the in-house expertise in commodity trade finance necessary for structuring transactions and managing commodity trade finance portfolios.

### **Business Characteristics and Risks**

The characteristics and risks associated with this type of business differ among the commodity producers, the processors, the marketers, and the pure commodity trading companies (traders). For the producers, important risk criteria include market position and scale, financial leverage, financial policy, and business risk profile. Examples of large, global, vertically integrated commodity producers and processors are Cargill, Bunge, Glencore Xstrata, and Trafigura, with substantial investments in farms (Cargill, Bunge) and mines (Glencore Xstrata, Trafigura). These companies are analyzed as commercial credits, but they do more derivative trading (to hedge risk associated with commodities) than typical corporate borrowers, and they engage in proprietary trading to enhance margins.

Pure commodity traders (i.e., physical commodity traders) are intermediaries between producers and commodity end users and are engaged only in buying and selling commodities; they are not involved in processing or production. These firms generate low margins (in the 1 percent to 3 percent range) and are thinly capitalized. It is common to see leverage ratios (defined as total debt/tangible net worth) for energy traders in the range of 10x and for coffee traders in the range of 7x. Assets consist principally of accounts receivable and inventories. The majority of pure commodity traders are privately held firms, with a few key individuals who trade as well as manage the operation.

Principal risks faced by pure commodity traders include (1) counterparty default risk (of suppliers and customers), (2) sales and supplier concentrations, (3) liquidity, (4) minimal capital, and (5) key man risk, in the case of firms owned and managed by one or two individuals. Pure commodity traders use financing principally to fund working capital and provide letters of credit to back commodity purchases. Producers, processors, and marketers use financing to fund capital expenditures and working capital needs.

Vertically integrated companies that supply or use commodities are viewed as lower risk than pure commodities traders. The vertical integration gives a company the ability to sell more of the commodity and reduce production of a vertically integrated product, or to reduce sales of the commodity and produce more of the vertically integrated product, hence providing diversification that can reduce earnings volatility.

Unless the commodity trading firm is publicly traded and required to publish quarterly and annual U.S. Securities and Exchange Commission filings, it is challenging to ascertain how much of the firm's buying and selling is for proprietary trading and how much is for hedging purposes. Bank due diligence and quarterly conversations with the firm's management and senior traders should include discussion of trading strategies and financial policies to gain an

understanding of the firm's risk appetite and, specifically, the extent to which proprietary trading is driving profits.

Successful commodity trading companies have the following characteristics:

- Ample liquidity to manage highly variable working capital needs driven by volatile commodity prices and margin calls on derivatives trades.
- Sophisticated risk management with the ability to effectively hedge commodity risk.
- Sufficient capital to cushion weak earnings periods.
- Strong relationships with clients and suppliers that minimize counterparties' willingness to default on supply or purchase contracts.

### Financing Structures

Basel II<sup>8</sup> defines commodities finance as structured, short-term lending to finance reserves, inventories, or receivables of exchange-traded commodities (e.g., crude oil, metals, and crops) where the exposure is repaid from the proceeds of the sale of the commodity and the borrower has no independent capacity to repay the exposure. This situation occurs when the borrower has no other activities and no other material assets on its balance sheet. In these transactions, a commodity trader makes a purchase (backed by a commercial letter of credit) from a producer. The bank takes security over the underlying commodity through the bill of lading and the assignment of receivables from the sale and delivery of the commodity. Advance rates range from 90 percent for billed receivables to 80 percent for inventory. Typically, a timing gap exists between the purchase and sale legs of a transaction, exposing the transaction to commodity price risk, thereby requiring the commodity trader to hedge the risk.

Commodity trade finance facilities are structured as bilateral (a credit agreement between one bank and one borrower) or syndicated revolving credit facilities (available for loans and letters of credit), often on an uncommitted basis. While lenders prefer to provide financing via syndicated credit facilities, clients may prefer bilateral facilities, which allow the clients to be less transparent with lenders about terms they have negotiated with other lenders. With bilateral facilities, however, a borrower is more vulnerable should one of its lenders exit a facility and the borrower is not able to replace that lender and financing on a timely basis.

The uncommitted structure of both bilateral and syndicated facilities translates into lower capital costs for lenders, which are reflected in the transactions' pricing structures. While the uncommitted structure provides lenders with the option not to fund a borrowing request, in the commodity trade financing space, borrowers view these financings as committed financings, and in fact, the relationship cost of not funding a borrowing request is sufficiently high that lenders also view these financings as committed facilities. The large global integrated commodities companies, however, have both committed and uncommitted credit facilities; they use committed credit facilities as backup for commercial paper issuance.

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<sup>8</sup> Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," June 2004.

The large vertically integrated producers and processors very often are able to borrow on an unsecured basis, while pure commodity traders are financed on a secured basis. Loan agreements with pure commodity traders typically are structured with frequent financial reporting requirements, such as audited annual financial statements due 90 days after the end of the fiscal year, monthly unaudited financial statements, and monthly statements of compliance with financial covenants. The structure of these financings is designed to compensate for the borrowers' weak credit quality. Loss given default ratios reflect the security and self-liquidating nature of the transaction.

Commodity trade financing presents risks associated with the borrower (credit risk), the specific commodity financed (market, price, and liquidity risks), and the monitoring of the loan portfolio (operational risk). Examiners should review the bank's commodity trade financing portfolio to evaluate whether the bank is identifying, measuring, monitoring, and controlling risks in this portfolio. (Updated October 15, 2018)

## Financial Supply Chain

The increase in global open account trade has created opportunities for financing goods as they move from supplier to buyer. In every trade transaction there is a conflict between the exporter, who wants to be paid as soon as possible, and the importer, who wants to delay payment as long as possible. Some banks attempt to resolve this conflict by providing financing options for the period between the payment date and the collection date. Typically, the exporter bears the cost of the financing through the discounting of its receivables, though at prices better than their normal cost of funds. On the other side, the importer may have a working capital line available at a bank. If the discounted rate on the receivables results in a cost of funds that is less than an extension from the importer's working capital line, the importer elects the receivables discounting option. The importer may benefit from this arrangement by negotiating to lengthen the payable time frames in the sales contract with the exporter or, in some cases, by sharing in the revenue the bank earns from the suppliers. This process of decoupling the payment date and the collection date is generally known as supply chain finance, but each bank may have unique characteristics to its program.

Under a supply chain finance arrangement, the importers provide their exporters with the opportunity to participate in an accounts receivable discounting arrangement with the bank. The bank receives electronic uploads of approved invoices from the importer and an instruction to pay the receivable at maturity date through a debit to an existing bank account. The participating exporter is notified of the scheduled payment and has the option to either automatically discount all receivables or select those receivables to be discounted. The bank advances the value of the receivables, less the discounting, to the suppliers in advance of the maturity date. During the period between the payment and collection dates of the receivables, the bank accepts the credit risk that the importer may not pay. This credit exposure should be approved in advance as part of the bank's risk appetite for credit from the importer.

There is nothing unique regarding the credit risk associated with this program. Instead, it is a process that uses existing financing products to solve an importer's concern that its suppliers have sufficient working capital to meet contractual obligations, without the importer or the



bank taking on credit risk to the supplier. (See the “Open Account Financing” section of this booklet for related information.) (Updated October 15, 2018)

## Trade Services

With the use of open accounts by international trade clients, greater competition from nonbank providers, and advances in trade technologies, banks are broadening the types of trade services they offer to meet their customers’ needs. These services may be, but are not limited to, Internet access for transaction initiation; electronic documents and tracking; trade processing services; and integrating cash management services with trade settlement and finance. The greatest risk to a bank that provides trade services to clients is operational risk, as trade activities remain heavily paper-based, leading to a significant potential for documentation errors and fraud.

The following are types of international trade services that banks may provide.

### Prepayment

The seller may require prepayment in the following circumstances: (1) the buyer has been in business for a short time, (2) the buyer has a poor credit history, or (3) the product is in heavy demand and the seller does not have to accommodate a buyer’s financing request in order to sell the merchandise. Prepayment eliminates all risks to the seller. The bank’s role in a prepaid transaction may be to transfer funds at the direction of the buyer to the seller or to provide credit information on either party to the other party.

### Open Account Trade

In addition to the financing opportunities associated with open account trade, there are trade services that the bank may provide to its clients. The bank may be the source of payments to the exporter at the direction of the importer. The bank may also provide limited documentary inspections or even verify that documents exist as a service to the importer. The bank would be acting solely as a service provider and would be under no obligation to make payments. (Updated October 15, 2018)

### Advising

In a commercial letter of credit transaction, the role of the bank is not limited to trade financing. The bank may serve as an advising bank, without a financing commitment as an issuing or confirming bank. As an advising bank, the bank acts as an agent of the issuing bank in authenticating and forwarding the commercial letter of credit to the beneficiary and makes no commitment on its part. The bank is potentially liable only for its own error in making the notification. The relationship with the issuing bank is often a correspondent bank arrangement.

## Trade Collections

In trade collections, the bank acts as an intermediary to facilitate the flow of documents and payments. There is no commitment or guarantee of payment from the bank. There are two types of collections: clean (financial document alone) and documentary (commercial documents with or without a financial document). A financial document is a draft or a check, while a commercial document is a bill of lading or other shipping document. Most trade collections are documentary.

In documentary collections, the payment can be settled in one of two ways:

- **Documents against payment (D/P):** The collecting bank releases documents to the importer only after the importer has fully paid for the underlying goods.
- **Documents against acceptance (D/A):** The exporter permits documents (and therefore the goods) to be released to an importer with the promise of payment at a fixed future date. The collecting bank presents the term or usance draft to the importer for acceptance. The usance or credit term is stipulated in the exporter's collection instructions. Having obtained the importer's acceptance, the collecting bank releases the documents to the importer, who can then clear the goods.

D/A collection is generally more risky for the exporter than D/P collection because the exporter runs the risk that the importer might refuse to pay on the due date. For example, the importer might find that the goods are not what were ordered, might not have been able to sell the goods, might be prepared to default on the transaction, or might have filed for bankruptcy. In contrast, under D/P collection, the exporter retains control of the relevant goods (via the presenting bank) until the importer pays. The exporter may choose D/A over D/P when the long-term business relationship with the importer is stable, there is minimal concern about the importer's ability to meet its payment obligations, the political and economic situation in the importer's country is stable, and there are no foreign exchange restrictions in the importer's country. (Updated October 15, 2018)

Documentary collection is more secure than open account but less secure than a letter of credit. An important advantage over open account is that the exporter's collection documentation, which effectively controls title to the goods, is not released to the importer until the importer makes the payment, accepts the draft, or issues a promise of payment or obligation to pay later.

## Bank-to-Bank Reimbursement Services

A bank-to-bank reimbursement facilitates the settlement of commercial letter of credit transactions between two banks that deal in different currencies or do not have an account relationship with each other. The issuing bank authorizes the paying bank to claim reimbursement for the amount it paid under the commercial letter of credit from the reimbursing bank designated in the letter of credit. The issuing bank designates a reimbursing bank with which it has established an account relationship.

The reimbursement designation authorizes the reimbursing bank to honor any conforming claim it receives from a paying bank (now referred to as a “claiming bank”) on receipt by debiting the issuing bank’s account. The reimbursing bank receives claims only. It does not receive or examine presentation documents under the commercial letter of credit. If the issuing bank’s account maintained at the reimbursing bank does not contain sufficient funds to cover a claim made on the reimbursing bank, the reimbursing bank is not obligated to honor the claim.

## Insourcing and Outsourcing Trade Processing

Trade finance and services are operationally intensive business lines. The continued global drive for automation and more rapid processing times creates continued cost pressures on banks offering trade activities. Some large banks are beginning to offer outsourcing solutions to other financial institutions by insourcing the work into the bank. The insourcing bank generally already maintains a full suite of trade services for its clients and has excess capacity or the ability to add capacity. The insourcing bank may provide comprehensive operational services or only select operations to the outsourcing bank. Insourcing banks may offer “white-labeling” solutions for banks that prefer that the outsourcing arrangement not be transparent to their clients. Insourcing banks assume additional operational and reputation risk and are expected to conduct all operations in a safe and sound manner. Examiners should consult the “Supervision of Technology Service Providers” booklet of the Federal Financial Institutions Examination Council’s (FFIEC) *Information Technology (IT) Examination Handbook* for guidance.

The outsourcing institution benefits from the ability to offer a wide variety of trade services, without taking on the costs and operational risk generally associated with maintaining a full trade finance and services infrastructure. Outsourcing institutions are subject to the risk that the insourcing bank fails to deliver services as agreed upon and should have an effective third-party risk management program in place. Refer to OCC Bulletin 2013-29; OCC Bulletin 2017-21, “Third-Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29”; and the “Outsourcing Technology Services” booklet of the *FFIEC IT Examination Handbook* for guidance. (Updated October 15, 2018)

Some global banks have established operational centers in offshore locations to process trade transactions, particularly for trade originated from the region. This arrangement is referred to as “offshoring.” Offshoring arrangements are normally developed to provide a lower-cost operating environment, obtain a greater knowledge of local and regional regulatory requirements, provide backup for essential operations globally, and minimize delays in processing caused by differing time zones. The required language skill is also an important factor in determining the offshore location. By locating transaction processing offshore, however, the bank is taking on an additional risk—country risk—to its operations. Examiners should consult the “Country Risk Management” booklet of the *Comptroller’s Handbook* for guidance on evaluating country risk.

## Hedging Services

Managers of the trade finance business line may use hedging strategies to help them control or reduce risk. Potential risks include price risk, interest rate risk, foreign-exchange risk, and country risk. Similarly, both an importer and an exporter may use the bank to help develop a hedge against a specific transaction, a complete hedging strategy, or anything in between. It would be unusual for the trade business lines to actually develop or implement the hedge. Normally, the capital markets area or affiliated brokerage firm is used to develop and implement the hedging strategy. If an examiner encounters a situation where the trade business lines fully manage their own hedging, the examiner should consult with an examiner with capital markets expertise.

## Risks Associated With Trade Finance and Services

From a supervisory perspective, risk is the potential that events will have an adverse effect on a bank's current or projected financial condition<sup>9</sup> and resilience.<sup>10</sup> The OCC has defined eight categories of risk for bank supervision purposes: credit, interest rate, liquidity, price, operational, compliance, strategic, and reputation. These categories are not mutually exclusive. Any product or service may expose a bank to multiple risks. Risks also may be interdependent and may be positively or negatively correlated. Examiners should be aware of and assess this interdependence. Refer to the "Bank Supervision Process" booklet of the *Comptroller's Handbook* for an expanded discussion of banking risks and their definitions. (Updated October 15, 2018)

Trade finance and services have all the risk categories noted above. Most significant among these risks are operational, compliance (particularly anti-money laundering [AML]), and credit. These risks are discussed more fully in the following paragraphs.

## Operational Risk

Historically, trade finance business has presented significant operational risk, as it relies heavily on paper documentation with manual processing. Larger banks are increasingly using technology to reduce that risk, lower unit costs, and reduce the likelihood of errors while increasing capacity, but operational risk remains significant. In contrast, some banks are considering reducing trade finance operational risk and technology overhead by outsourcing their trade processing to a full-service trade finance bank.

Those banks that process trade finance and services in-house are exposed to operational risk at every point of the life cycle of the product. To better understand the operational risk embedded in all trade activities, consider some of the operational risks that a commercial letter of credit poses to a bank. Initially, there is the risk that originating documents are

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<sup>9</sup> Financial condition includes impacts from diminished capital and liquidity. Capital in this context includes potential impacts from losses, reduced earnings, and market value of equity.

<sup>10</sup> Resilience recognizes the bank's ability to withstand periods of stress.

flawed (for example, if the letter of credit is not signed by a person authorized by the client and the bank); nonstandard language is used that invalidates traditional protections to the bank; or the terms are unclear. Once the commercial letter of credit has been issued, the bank is subject to any documentation errors it may include. All instructions generally are input into the bank's operating system manually, which could lead to errors.

There is also significant risk when the commercial letter of credit is presented for payment. Missing documents or errors on submitted documents may slow the processing of the payment. Further, if the bank neglects to identify missing documents or errors, it places itself at risk if the exporter has not met all the terms of the purchase contract. As the terms and conditions of a purchase of goods usually change over the term of the contract, the bank should have a process to verify that the changes are valid and that the bank is apprised of all changes. Once all documents have been reviewed and verified, a bank should check for availability under the line of credit. There is also operational risk in the process to input payments. This discussion is not meant to be inclusive of all the operational risk inherent in the processing of a commercial letter of credit but rather is meant to inform examiners of the complexity of the operating environment for trade activities. (Updated October 15, 2018)

The potential for documentation fraud is high in international trade transactions. For example, to evade customs regulations, goods may be over- or under-priced, inaccurately invoiced, or misrepresented in the quantity or type of goods imported or exported. Thus, inadequate processes for documentation review and reporting of exceptions or unusual activities can expose the bank to losses or fines.

While banks may use third-party guarantees or insurance to reduce credit risk on trade loans to clients, there is operational risk involved. If the bank has not followed the program requirements in servicing the loan, the guarantee or insurance policy may not be honored.

Some banks have outsourced trade operations to a third party. The operational risk associated with outsourcing should be clearly understood by the bank. For example, a poorly written contract could lead to untimely processing and settlement of trade or breach of data security and confidentiality, potentially exposing the bank to litigation. Banks that provide servicing activities should have sufficient capacity, internal controls, and expertise to manage the incremental risk from insourcing operations. For additional guidance, examiners should consult OCC Bulletin 2013-29, OCC Bulletin 2017-21, and the "Outsourcing Technology Services" and "Supervision of Technology Service Providers" booklets of the *FFIEC IT Examination Handbook*. (Updated October 15, 2018)

## Trade Finance Technology

Banks have increasingly turned to technology to automate key aspects of their operations. Banks may acquire hardware and incorporate software packages to help conduct processing and manage the risks of trade transactions. These systems may handle such functions as electronic documentation, discrepancy detection, matching and filtering names against Office

of Foreign Assets Control (OFAC) sanction lists,<sup>11</sup> payment processing, and other trade-related functions. Increasingly, the Internet is being used to streamline the execution of trade transactions and related functions. Through these systems, banks gain easier documentation and record keeping of transactions, mechanisms to monitor adherence to regulatory requirements, and increased speed in the execution of transactions. (Updated October 15, 2018)

Use of these systems, however, may entail certain operational risks that banks should mitigate. For example, some systems interface with major wholesale payments systems and messaging services like SWIFT<sup>12</sup> or various clearinghouses, which allow bank employees to make fund transfers. Hackers and other similar cyber-based threats could compromise Internet-based transactions if they are not properly secured by appropriately authenticated communication and document transfer and storage.

To properly incorporate these technology platforms into the bank's daily operations, these systems should meet the bank's operational requirements and be designed with adequate controls to mitigate any potential risks. For more information on payment systems, information security requirements, and software controls, see the "Wholesale Payment Systems," "Information Security," and "Development and Acquisition" booklets of the *FFIEC IT Examination Handbook*. (Updated October 15, 2018)

## Settlement of Trade Transactions

The operational risk associated with trade transaction payment processing should not be overlooked. The risk is particularly high for large banks due to their complex telecommunications networks and high transaction volume. These banks use payment message systems such as SWIFT to originate payment orders, either for their own benefit or for a third party. These message systems process administrative messages and instructions to move funds. Even though such payment orders do not result in the immediate transfer of funds from the issuing bank, they do result in the issuing bank having immediate payment liability that is payable to the disbursing institution.

While less complex banks also use messaging systems to originate payment instructions to their correspondent trade banks, some banks still rely on telephone, fax, or standing instructions for payment order originations.

Because the payment order is the institution's authorization to act on behalf of the customer, it is imperative that the bank have adequate experienced staff and systems to control the associated operational risks, such as physical access, information security, authentication of

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<sup>11</sup> Refer to the U.S. Department of the Treasury's Office of Foreign Assets Control's "Sanctions Programs and Information" website.

<sup>12</sup> The Society for Worldwide Interbank Financial Telecommunication (SWIFT) is the financial industry-owned cooperative that supplies secure, standardized messaging services and interface software to over 9,700 financial institutions in more than 200 countries. SWIFT's worldwide community includes banks, broker/dealers, and investment managers, as well as their market infrastructures in payments, securities, treasury, and trade.

signatures, and input errors. For additional information on processing payments, see the “Payment Systems and Funds Transfer Activities” booklet of the *Comptroller’s Handbook*.

## Compliance Risk

Compliance risk in trade transactions includes the failure to comply with domestic and international laws such as the Bank Secrecy Act (BSA), AML regulatory requirements, the anti-boycott regulations issued pursuant to the former Export Administration Act, or sanctions regulations enforced by OFAC, as well as similar requirements in a foreign jurisdiction. Noncompliance with these laws may result in monetary penalties and prevent the bank from collecting on a transaction. Additionally, for banks that have affiliated export trading companies, bank management should understand the requirements of sections 23A and 23B of the Federal Reserve Act (12 USC 371c and 12 USC 371c-1). For a summary of legislation and other legal issues relevant to trade financing, see appendix E. (Updated October 15, 2018)

The international trade system is subject to a wide range of risks and vulnerabilities that provide criminal organizations with the opportunity to launder the proceeds of crime and move funds to terrorist organizations with a relatively low risk of detection. While banks should be alert to transactions involving higher-risk goods (e.g., trade in weapons or nuclear equipment), they need to be aware that goods may be over- or under-valued in an effort to evade AML or customs regulations, or to move funds across national borders. For more specific guidance on examining money laundering and terrorist financing risks related to trade finance activities, refer to the *FFIEC Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual* and guidance available through OFAC, including the OFAC Web site.

It is important for banks to be aware of the laws of the country in which the counterpart to the domestic client is located. For this reason, many banks rely on foreign correspondent bank relationships in the countries where they are active but lack branches. In addition, the contract should include a choice of laws clause, specifying which country’s or countries’ laws will apply in the event of a dispute over the terms of the contract. Although courts may not always enforce such clauses, in many cases they can provide an additional measure of certainty for managing the risk inherent in a cross-border contract.

## Credit Risk

(Section updated October 15, 2018)

Trade finance is a specialized area, and a bank that lacks the appropriate expertise may experience credit losses because of weak structuring, poor documentation, or unfamiliarity with a country’s business practices, economic or political climate, and laws. The products that a bank uses to finance trade, however, are generally no different from the products used in the commercial loan area. A bank’s underwriting standards should address the source of repayment; repayment terms; collateral and documentation requirements; pricing; and, as appropriate, third-party guarantees or insurance, and covenant requirements. Many banks

centrally manage the level of credit risk they are willing to take with each client, country, or industry. A portion of the exposure approved for a client may be allocated to trade finance to meet the client's trade financing needs. The trade finance business line should manage individual client exposures as well as the risk in the portfolio as a whole.

Traditionally, international trade finance is considered a lower-risk activity for banks because loans are generally short-term, self-liquidating, and collateralized by the underlying trade goods. The loans are considered self-liquidating in that the goods acquired via the financing are sold, with the proceeds used to repay the loan. Some banks, however, are extending longer-term credit, up to 15 years, as part of export credit agency relationships. Although these credits are generally guaranteed by a government or quasi-government agency, the guarantee may not cover 100 percent of the extension of credit. Additionally, if the terms and conditions imposed by the agency are not met, the bank risks losing the guarantee.

Generally, clients using commercial letters of credit for financing the acquisition of goods have established a line of credit with the bank. The line approval and review process should reflect the credit discipline in place in the commercial portfolio. Commercial letters of credit issued without a supporting line of credit normally are expected to be paid by the client through a funds transfer when the letter of credit is presented for payment with complete and conforming supporting documents. If the client does not have available funds, the bank may have an unintended extension of credit. Therefore, the bank should review each letter of credit client as it would any borrower, regardless of anticipated method of payment.

In confirming a foreign bank's letter of credit, the bank should evaluate the risk that the foreign bank may not be able to raise the dollars required to repay the transaction because of currency controls in the importing country. Banks engaging in open account financing should understand the relationship and credit quality of the importer and exporter. In banker's acceptance financing, the acceptance credit risk depends on the acceptance term and the method by which the bank acquired the acceptance. To properly identify and evaluate the sources of repayment, the examiner should review each trade finance product or transaction individually.

Historically, economically distressed countries have placed a high priority on the payment of foreign trade obligations when allocating scarce foreign currency reserves among external debt payments (reducing transfer risk). More recent economic and debt crises in some countries, however, have underscored that the priority status of trade-related credits is not as meaningful as it once was. These developments have raised the implied level of risks in the international trade credit portfolio.

The amount of due diligence performed by the bank should be appropriate for the type and complexity of financing provided and the level of country and transfer risks that the bank is taking on. The Interagency Country Exposure Review Committee (ICERC) reviews and evaluates trade finance credits for transfer risk. The definition of what qualifies as trade credit for purposes of the ICERC's transfer risk ratings typically does not include the liberal



interpretation of an unsecured, revolving line of credit to a foreign bank that is then recycled as an operating loan to a local importer or exporter.<sup>13</sup>

For banks with substantial international activities, examiners normally schedule a country risk management examination, independent of the review of the trade finance business. In other large banks with international activities, examiners should determine whether an independent country risk management examination is appropriate after evaluating the volume, complexity, and risk of the international operations. In midsize and community banks, examiners normally prefer to perform a country risk review in conjunction with a trade finance review.

Examiners should consult the “Rating Credit Risk” booklet of the *Comptroller’s Handbook* for discussions on the relationship between credit risk and transfer risk, as well as informal or implied government guarantees in the evaluation of trade credit; the “Country Risk Management” booklet for additional information on evaluating country risk, which includes transfer risk; and the “Accounts Receivable and Inventory Financing,” “Asset-Based Lending,” and “Commercial Loans” booklets for guidance on the various methods of trade financing.

## Liquidity Risk

Banks may purchase banker’s acceptances created by other banks as short-term money market assets. Should the bank need to obtain funds, it may sell the banker’s acceptances. Banker’s acceptances are not traded on an organized exchange, but there is a secondary market that has grown substantially over the last decade. Because the maturities of most banker’s acceptances are short and “name” banks dominate acceptance financing, the market generally views banker’s acceptances as safe and liquid. Liquidity risk is greater if the accepting bank is considered to be in weaker financial condition or is not a “name” or “prime” institution, or if the instrument is not eligible for Federal Reserve discount. Please see appendix B for information relating to discounting banker’s acceptances at the Federal Reserve Banks.

## Price Risk

Banks with foreign operations likely have transactions and financial statements that are denominated in foreign currencies. Fluctuations in exchange rates associated with the conversion of these foreign currency transactions and financial statements can result in either a transaction gain or loss that is recorded in current earnings or a translation adjustment that is recorded in capital. An assessment of this exchange rate risk to earnings or capital should be performed on a bank-wide basis, considering all transactions and investments that are denominated in foreign currencies, because the bank may have offsetting risk positions. For example, a bank may have a foreign currency-denominated trade transaction that is funded in

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<sup>13</sup> See OCC Bulletin 2009-8, “Country Risk: Changes to the Interagency Country Exposure Review Committee Process,” and “Guide to the Interagency Country Exposure Review Committee Process,” November 2008.

the same currency as the trade transaction that it is financing, offsetting the exchange rate risk. (Updated October 15, 2018)

A bank financing an exporter's operation by discounting foreign currency-denominated drafts or acceptances encounters foreign currency exchange rate risk (assuming it is not hedged or otherwise offset). The U.S. bank is exposed to the transaction risk from the time it discounts the instrument and pays the local currency exporter the dollar equivalent of the draft or acceptance until it collects from the foreign counterpart in the foreign currency. If the foreign currency depreciates in relation to the dollar between when the bank pays the exporter and when the bank collects on the foreign instrument, the bank incurs a foreign-exchange transaction loss.

Some trade finance transactions that are U.S. dollar-denominated may, under certain conditions, become payable in local currency, thereby exposing the bank to foreign currency exchange rate risk. One example would be trade transactions that include alternative payment instructions in the event of a transfer risk event (also known as inconvertibility) occurring in the country where the foreign importer is located. The payment instructions may also stipulate that, if U.S. dollars become available, they should be remitted to the exporter's U.S. bank. Exposure to exchange rate risk arises if the U.S. bank elects to discount the draft instead of waiting for the U.S. dollars to become available for remittance. For additional information about foreign-exchange risk, see the "Foreign Exchange" booklet of the *Comptroller's Handbook*. (Updated October 15, 2018)

## Interest Rate Risk

Banks that primarily engage in trade financing do not have substantial interest rate risk given the relatively short tenor and floating interest rates. Interest rate risk rises when the terms of the financing include for a longer tenor (e.g., aircraft) and fixed interest rates (e.g., export credit agencies). Banks, however, may use hedging strategies to help manage the interest rate risk on a transaction or a portfolio basis. OCC assessment of interest rate risk to bank earnings and capital is normally performed by the examiner assigned to review interest rate risk on a bank-wide basis.

## Strategic Risk

Strategic risk in trade activities arises when a bank does not know enough about the country or region in which it is doing business, the risks of the product that it is offering, or the complexity of implementing new products. It also arises from misjudgments of competition or customer demand. A bank considering entering into or expanding international trade finance and services activities should carefully develop its trade business strategy (see OCC Bulletin 2017-43, "New, Modified, or Expanded Bank Products and Services: Risk Management Principles"). (Updated October 15, 2018)

## Reputation Risk

Reputation and market perception are particularly important in trade finance and services. Issuing commercial letters of credit requires expedient processing and significant attention to detail. A bank's failure to meet these requirements may result in financial losses to the bank and its customers and may diminish the bank's business opportunities in the trade community. Banks may use trade management logistics planning software, which is designed to help corporate clients manage their global trading operations. This software may incorporate customs regulations and other international trade data such as duty rates, licensing requirements, and value added tax rates. Inaccurate or untimely updates could potentially subject the bank to dispute or litigation.

In the case of banker's acceptances, a bank lends its name to support a transaction. Therefore, it is important that the customer requesting the banker's acceptance transaction have a sound reputation. As for the banks, banker's acceptances generally are created by reputable, well-known banks with a good credit standing, making such instruments generally safe. (Updated October 15, 2018)

The international trade system is vulnerable to documentary fraud and criminal activities to launder the proceeds of these activities. The involvement of multiple parties on both sides of the international trade transaction can make the process of due diligence and detection more difficult. Noncompliance with the BSA and AML regulatory requirements may damage a bank's reputation and result in monetary penalties. (Updated October 15, 2018)

## Risk Management

(Section updated October 15, 2018)

The OCC expects each bank to identify, measure, monitor, and control risk by implementing an effective risk management system appropriate for its size and the complexity of its operations. When examiners assess the effectiveness of a bank's risk management system, they consider the bank's policies, processes, personnel, and control systems. Refer to the "Corporate and Risk Governance" booklet of the *Comptroller's Handbook* for an expanded discussion of risk management.

While organizations, boards, and management should be aware of individual risks associated with trade activities (such as those discussed in the "Risks Associated With Trade Finance and Services" section of this booklet), the importance of having a comprehensive and integrated approach to risk management has increased in an environment that is becoming more and more complex. This complexity is reflected in (1) the structure of many institutions, (2) the products and services being developed, (3) the technology being used to deliver products and services and to interface with customers, (4) the competition in the marketplace, and (5) the global presence of institutions.

A bank's trade policy should have a board- or board committee-approved risk appetite statement that clearly communicates the amount of risk as a percentage of capital that the

bank is willing to take in pursuing its strategic objectives in trade finance and services activities. The policy should, for example, identify the products, target markets, prospective customers, and desirable countries. It also should set limits, documentation requirements, and parameters for monitoring and reporting.

A central lesson from past financial crises is that concentrations can accumulate across products, business lines, countries, customers, and legal entities within a bank. Hence, a sound risk management process for measuring and monitoring concentration risk arising from the bank's trade finance activities is essential. For additional guidance, examiners should consult the "Concentrations of Credit" booklet of the *Comptroller's Handbook*.

The bank's processes should be documented in a complete manner and should include, as appropriate, narrative descriptions, flowcharts, copies of forms, or other pertinent information for consistent implementation of policies. Banks may introduce new, modified, or expanded trade products or services to stay competitive, improve efficiency, or enhance profitability. Therefore, a bank should have processes for developing new, modified, or expanded products and services consistent with sound risk management. Bank management should effectively measure, monitor, and control the risks associated with new, modified, or expanded products. Such products should align with the bank's risk appetite and should be consistent with its capability and capacity to manage the associated risks. (Refer to OCC Bulletin 2017-43 for more information regarding new, modified, or expanded bank products and services.)

Sound customer due diligence procedures for gaining a thorough understanding of trade customers' underlying businesses are critical (1) to mitigate the risk that the bank will be used as a conduit for money laundering or terrorist financing, and (2) to comply with regulations implementing the BSA. The *FFIEC BSA/AML Examination Manual* discusses factors that banks should consider and steps they can take against money laundering activities. In addition, sound due diligence includes screening transactions and associated names against OFAC sanction lists.

The importance of strong internal controls in trade finance and services cannot be overemphasized. In commercial letters of credit, incidences of counterfeit goods totaling millions of dollars, are often not identified in a timely manner, and significant amounts of funds can be released before the schemes are detected. Banks should closely monitor commercial letter of credit transactions. Inadequate control over both information security and physical access to payment systems raises the risk of unauthorized access to customer data and funds transfer. A well-organized and efficient back-office operation is essential to the control environment.

Banks should have competent managers and experienced staff to oversee or execute trade business and trade operations in a safe and sound manner. In addition, the board of directors and management should receive timely, accurate, and useful information, including exceptions reporting, to evaluate the risk levels and performance of the trade business.

Banks that offer incentive compensations to their employees should have a well-designed incentive compensation program that aligns with the bank's strategic objectives and risk tolerance and is consistent with the safety and soundness of the organization. The program should be approved by the board of directors and (1) provide employees with incentives that appropriately balance risk and reward; (2) be compatible with effective controls and risk management; and (3) be supported by strong corporate governance, including active and effective oversight by the organization's board of directors. The program should be reviewed regularly to evaluate its effectiveness. For additional guidance, examiners should consult OCC Bulletin 2010-24, "Interagency Guidance on Sound Incentive Compensation Policies."

## Risk Controls

(Section updated October 15, 2018)

As with any line of business, the most effective way to control risk is through a strong risk management process. Management also can use other methods, including the hedging of risk and the outsourcing of operations discussed earlier in this booklet, to control the amount of risk it accepts on the bank's balance sheet.

Some large banks have developed an originate-to-distribute operating model that is designed to reduce the bank's balance sheet credit exposure by selling trade finance credit outright or entering into participation agreements with other banks. Before engaging in such transactions, bank management should be confident the bank can sell the credit exposure in a timely manner and at a price that meets the bank's internal return requirements. Examiners should consult the "Asset Securitization" booklet of the *Comptroller's Handbook* for guidance. Credit sold with recourse should be closely monitored and accurately reported. Sales or participation programs allow financial institutions to purchase trade exposure to business lines, companies, or specific geographies without having to build infrastructure to support the business line. Sales or participation programs also allow banks that are concentrated to obtain a more diversified portfolio. Banks that are active in originating trade credits to distribute may also be purchasers from another institution to protect relationships. Refer to OCC Banking Circular 181 (Rev), "Purchases of Loans in Whole or in Part-Participations," for more information. The trade finance industry also considers additional distribution channels in nonbank financial institutions, such as insurance companies and large employee benefit plans.

Smaller banks' trade finance activities may be constrained by their funding capacities. To mitigate the funding and liquidity risk, they may purchase risk participations with the Private Export Funding Corporation (PEFCO).<sup>14</sup> To be eligible with PEFCO, all trade credits must be protected against nonpayment under an appropriate guarantee or insurance policy issued by the Ex-Im Bank. Examiners should review the programs to evaluate the residual risk to the bank, for example, retention of the unguaranteed or uninsured portion and the servicing risk of the Ex-Im Bank loan.

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<sup>14</sup> PEFCO is a private corporation owned by major U.S. commercial banks, industrial companies, and financial services companies. It is not backed by the U.S. government, but the U.S. Ex-Im Bank has cooperated in the operation of PEFCO through various agreements.

The industry is in the early stages of developing a market for securitizing trade finance credit. Some banks have entered the securitization process through a partnership with other banks, with each bank contributing agreed-upon credits of acceptable risk rating and each participating member holding a share of the securitization. Participation in securitizations is another method used to increase the diversification in a bank's trade portfolio.

# Examination Procedures

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This booklet contains expanded procedures for examining specialized activities or specific products or services that warrant extra attention beyond the core assessment contained in the “Community Bank Supervision,” “Federal Branches and Agencies Supervision,” and “Large Bank Supervision” booklets of the *Comptroller’s Handbook*. Examiners determine which expanded procedures to use, if any, during examination planning or after drawing preliminary conclusions during the core assessment.

## Scope

These procedures are designed to help examiners tailor the examination to each bank and determine the scope of the trade finance and services examination. This determination should consider work performed by internal and external auditors and other independent risk control functions and by other examiners on related areas. Examiners need to perform only those objectives and steps that are relevant to the scope of the examination as determined by the following objective. Seldom will every objective or step of the expanded procedures be necessary. See appendix H for a sample request letter.

**Objective:** To determine the scope of the examination of trade finance and services and identify examination objectives and activities necessary to meet the needs of the supervisory strategy for the bank.

1. Review the following sources of information and note any previously identified problems related to trade finance and services that require follow-up: (Updated October 15, 2018)
  - Supervisory strategy
  - Examiner-in-charge’s (EIC) scope memorandum
  - OCC’s supervisory information systems
  - Previous reports of examination (ROE), supervisory letters, risk assessments, and work papers
  - Internal and external audit and credit review reports and work papers
  - Bank management’s responses to previous ROEs, supervisory letters, and audit and credit review reports
  - Customer complaints and litigation. Examiners should review customer complaint data from the OCC’s Customer Assistance Group, the bank, and the Bureau of Consumer Financial Protection (when applicable). When possible, examiners should review and leverage complaint analysis already performed during the supervisory cycle to avoid duplication of effort.
2. In discussions with bank management, determine
  - how management supervises the portfolio.

- any significant changes in business strategies, including products, volumes, and geographic and market focus since the previous examination of trade finance and services.
  - material changes in policies, processes, personnel, and control systems since the previous examination of trade finance and services.
  - levels and trends in delinquencies and losses for the activities.
  - any internal or external factors that could affect trade finance and services business and operations.
3. Depending on findings obtained in the previous steps, obtain and review applicable policies, procedures, management reports, and other bank internal documents for trade finance and services. These may include, but are not limited to, the following:
- Board-approved risk appetite statement
  - The bank's current trade strategy and business plan
  - Descriptions of trade products and programs offered
  - Organization chart, including names of key trade management and personnel
  - Résumés detailing experience of key trade management and personnel
  - Formal job descriptions for all key trade positions
  - Board-approved compensation and, as applicable, incentive programs
  - Reports to the board or relevant board committee
  - Board or relevant committee minutes
  - Internal bank reports that management uses to supervise trade activities, including
    - internal risk assessments
    - profitability report along with the budget and revisions, if any
  - Trade exposure or volume reports
  - Exceptions reports
  - Delinquency reports
  - Trade finance clients that are classified or special mention
  - Losses and recoveries by product, including a brief description, date, and amount
  - Participation purchased and sold
  - Top trade clients and, if applicable, the countries where the relationship is managed
  - Process used to manage credit risk in the trade finance portfolio
  - Pending litigation affecting trade product line
  - Deal reviews performed
4. Based on an analysis of information obtained in the previous steps, as well as input from the EIC, determine the scope and objectives of the trade finance and services examination.
5. Select from the following examination procedures the necessary steps to meet examination objectives and the supervisory strategy. (Updated October 15, 2018)



## Quantity of Risk

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**Conclusion:** The quantity of each associated risk is (low, moderate, or high).

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**Objective:** To determine the level of strategic risk associated with trade finance and services.

1. Evaluate the strategic risk within the bank's trade business. Consider
  - the bank's trade strategy and any planned changes.
  - profitability trend and variance from budget.
  - due diligence process for new products and services.
  - management knowledge of countries and regions.
  - records of successful implementation of trade strategic plan and business initiatives.
  - effects of external factors, including economic, industry, competitive, and market (e.g., pricing) conditions.
  - effects of potential legislative, regulatory, accounting, and technology changes.

**Objective:** To determine the level of reputation risk associated with trade finance and services.

1. Evaluate the reputation risk within the bank's trade business. Consider
  - extent of formalization of reputation risk management policy.
  - type and volume of large or complex transactions escalated for senior management assessment for reputation risk.
  - volume of customer complaints and pending litigation arising from the trade business.
  - volume of trade transactions in high-risk or socially controversial industries (e.g., military, arms, environmental industries, and countries associated with illegal drugs and money laundering).
  - management's response to regulatory, economic, or market changes that could affect reputation risk.
  - adequacy of internal controls and risk management systems.
  - financial condition of the bank.

**Objective:** To determine the quantity of credit risk associated with trade financing.

1. Evaluate the types of trade financing (including guarantees issued) and their customer base. Determine the implications for risk of the following:
  - Volume and growth trend.
  - Significant clients and relationships.
  - Concentration as a percentage of total capital.
  - If applicable, participations purchased or sold and whether with or without recourse.
  - Use of third-party guarantee or insurance programs.

2. Assess the level of country exposure and transfer risk involved. Examiners do not need to perform this procedure if the bank is subject to an independent country risk management examination. Consider
  - size of existing exposure to countries.
  - country exposure growth trend.
  - level of exposure to higher-risk countries as a percentage of total capital. Review bank's internal country risk rating system, credit agencies ratings, and ICERC ratings.
  - size of country limits.
  - concentration of country risk.
3. Evaluate the bank's strategic and business plan for the trade finance business. Discuss with management as applicable. Consider
  - targeted client segments and growth goals.
  - planned entrance into new countries.
  - implications of economic environment and competition on client growth strategy.
4. Based on review of bank internal reports and discussions with management, as applicable, determine
  - level of standby letters of credit that have been drawn.
  - volume of banker's acceptances with failed repayments.
  - trade credit delinquency trend.
  - volume of criticized and classified trade credits.
  - trade credit losses and recovery trend.
  - volume and nature of credit exceptions (e.g., credit approval/limit) associated with trade credits.
5. Select a sample of trade finance transactions to be reviewed and complete the line sheets. The sample should be adequate to test trade finance portfolio credit risk, including the risk rating, quality of underwriting, loan documentation, and compliance with bank policies and procedures. For guidance on sampling techniques, refer to the "Sampling Methodologies" booklet of the *Comptroller's Handbook*. For guidance on risk rating, refer to the "Rating Credit Risk" booklet of the *Comptroller's Handbook*. In addition, examiners should consult the "Accounts Receivable and Inventory Financing," "Asset-Based Lending," and "Commercial Loans" booklets of the *Comptroller's Handbook* for guidance related to accounts receivable financing, factoring, forfaiting, and loans to commodity traders.
6. Select a sample of countries to test the adequacy of country risk analysis performed by the bank and the country risk rating assigned. Examiners do not need to perform this procedure if the bank is subject to an independent country risk management examination. For guidance on country risk, review the "Country Risk Management" booklet of the *Comptroller's Handbook*.

**Objective:** To determine the quantity of operational risk associated with trade finance and services.

1. Evaluate the trade portfolio volume, complexity of transactions, and growth in the trade finance and services business. Consider
  - formalization and sophistication of control environment.
  - new products.
  - geographic expansion.
  - the type and volume of activities that have been outsourced or moved offshore.
  - whether the bank is a service provider.
  - system changes, conversion, and integration.
  - external factors such as competition and regulatory and political changes.
2. Determine the volume and nature of operation errors and policy exceptions (e.g., documentation, processing, collateral, and program requirements) and their resolutions.
3. Evaluate the volume, nature, and trend of customer complaints, disputes, litigation, losses, and recoveries resulting from trade finance and services operations (e.g., input errors, delays in processing, contract disagreements, physical access security breaches, system compromises, deviations from documentary collection instructions, signature authentication errors, misconduct of people, and guarantee or insurance program servicing requirements not being followed).
4. If applicable, determine the implications for operational risk associated with third-party service provider arrangements (e.g., due diligence in selection, contract, performance measures, confidentiality, and oversight). Refer to OCC Bulletin 2013-29; OCC Bulletin 2017-7, “Third-Party Relationships: Supplemental Examination Procedures”; and OCC Bulletin 2017-21, “Third-Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29.” (Updated October 15, 2018)
5. Evaluate external threats such as market disruptions, cyber attacks, etc.
6. Consider the technology risk in the bank’s trade finance and services business. This risk includes evaluating
  - communication and document transfer among the locations where trade finance and services is a line of business, in whole or in part.
  - the effectiveness of the bank’s authentication procedures for any document received electronically to support trade finance and services.
  - any software used to monitor and store any trade process.

In general, evaluation of the technology risk should follow the guidance in the applicable *FFIEC IT Examination Handbook* booklet: “Development and Acquisition,” “Information Security,” “Outsourcing Technology Services,” and “Supervision of Technology Service Providers (TSP).” As appropriate, the examiner should consult with

the EIC and examiner assigned to review the bank-wide information technology functions.

7. Select a sample of transactions to test the operational risk in trade finance and services. Evaluation of operational risk associated with trade loans should, in general, follow the guidance in the applicable *Comptroller's Handbook* booklet: "Accounts Receivable and Inventory Financing," "Asset-Based Lending," and "Commercial Loans."

### **Letters of Credit**

1. Select a sample of commercial letters of credit to
  - review the documents for completeness. Consider the document type (transfer, insurance, commercial, etc.) relative to the transaction. Determine whether any documents are missing.
  - assess the quality, accuracy, and appropriateness of documentation related to the transactions.
  - compare the invoice information (terms, merchandise descriptions, etc.), receipts, delivery documents, and bills against information documented in the letter of credit instruments.
  - determine any documentation discrepancies and amendments without approvals.
  - assess daily transaction records to determine the level of bookkeeping adjustments required.
2. Determine whether standby letters of credit are correctly segregated from other types of letters of credit and guarantees.

### **Banker's Acceptances**

3. Select a sample of banker's acceptances to determine whether the basic documentation for a banker's acceptance consists of
  - a banker's acceptance credit agreement that contains the borrower's promise to repay the bank when the acceptance matures.
  - a purpose statement or letter from the borrower that describes the underlying trade transaction being financed, certifies that no other financing is outstanding, and specifies that the transaction has not been refinanced.
  - a bill of exchange.

### **Advising**

4. Select a sample of advised letters of credit and determine the following:
  - Correspondent agreements with the issuing bank exist and outline responsibilities and fees.

- Bank's notification has been performed in a timely manner as specified in the correspondent agreement.
- Language in the transmittal clearly discloses that the bank is acting solely in an advising capacity and makes no commitment regarding the letter of credit.
- Terms of the letter of credit have been correctly transmitted to the beneficiary.
- The amount of claims resulting from errors or delays in the transmission of the letter of credit to the beneficiary.
- Advised letters of credit are clearly segregated from confirmed and issued letters of credit.

### Trade Collections

5. Select a sample of D/P and D/A items and determine
  - aging of drafts (collections) outstanding.
  - any unusual situations, such as nonacceptance of goods and possession of goods without payment.
  - for D/P collections, whether documents are released after payment.
  - for D/A collections, whether exporter's collection instructions are followed.
  - for disputed items, dishonor, and protest instructions, whether bank staff promptly notifies the parties of these situations as well as escalation processes for unresolved items.
  - whether fees earned are received in a timely manner and appropriately recorded in the bank's books. Review the relationship between the amount collected in a month and the correspondent banks involved in the collection process.

### Bank-to-Bank Reimbursements

6. Select a sample of outstanding reimbursement orders for the last 12 months (a shorter time frame may be appropriate if level of activity is significant). Determine
  - the amount, the correspondent bank, and the foreign currency involved in the transaction.
  - whether the bank has overdrafts in the correspondent accounts without loan arrangements with the correspondent.
  - whether foreign-exchange conversion is verified by an independent party before finalizing the accounting entries.
  - whether the bank's account is correctly debited.

**Objective:** To determine the quantity of compliance risk associated with trade finance and services.

### BSA/AML and OFAC

1. Consider the BSA/AML and OFAC compliance risk in the bank's trade finance portfolio. Evaluation of BSA/AML and OFAC compliance risk should use the guidance and

examination procedures in the *FFIEC BSA/AML Examination Manual* sections for trade finance and OFAC. As appropriate, the examiner should consult with the EIC and examiner assigned to review the bank-wide BSA/AML and OFAC compliance.

### **Anti-Boycott Regulations Issued Pursuant to the Former Export Administration Act of 1979**

2. Consider anti-boycott provisions for issuance of letters of credit (15 CFR 760.2), generally, and 15 CFR 760.2(f) with respect to letters of credit, specifically. Confirm that
  - bank is not engaging in transactions related to unsanctioned foreign boycotts.
  - letter of credit instruments do not contain illegal boycott terms.
3. Consider reporting requirements for anti-boycott provisions (15 CFR 760.5). Determine whether the bank reports any written or oral information about unsanctioned foreign boycotts.
4. Consider exceptions to prohibitions (15 CFR 760.3). Determine whether the bank reports agreements to comply with permissible requirements of import documents, such as nonexclusionary certifications of origin, and import requirements denying entry to goods and services from nationals and residents of certain nations.

### **Export Trading Company Act of 1982**

5. If the bank has an affiliated export trading company, determine compliance with the transactions with affiliates restrictions and collateral requirements of 12 USC 371c, 12 USC 371c-1, or 12 CFR 223 (Regulation W). (Updated October 15, 2018)

### **Banker's Acceptances**

#### National Banks

6. Determine whether any acceptances have been issued on behalf of an affiliate that would constitute extensions of credit under 12 USC 371c, 12 USC 371c-1, and 12 CFR 223 (Regulation W) (on transactions with affiliates).
7. Determine compliance with 12 USC 372, which limits the aggregate amount of acceptances outstanding and the amount of acceptances that may be created for any one customer.
8. Evaluate compliance with 12 USC 373 (on acceptance of drafts for furnishing dollar exchange) by
  - identifying acceptances issued to furnish dollar exchange.
  - determining whether those acceptances comply with the prescribed limits.

9. Determine the applicability of 12 CFR 7.1007 to banker's acceptances used in financing credit transactions.
10. Determine whether acceptances of other banks purchased are of the kinds described in 12 USC 372 and 12 USC 373 (i.e., they are eligible acceptances and are therefore not subject to any limit based on capital and surplus).
11. Determine whether a banker's acceptance conveyed through participation to a junior bank has been excluded from the senior bank's aggregate limits per 12 CFR 250.165.

#### FSAs

12. Determine whether any acceptances have been issued on behalf of an affiliate that would constitute extensions of credit under 12 USC 371c, 12 USC 371c-1, 12 CFR 223 (Regulation W), or 12 USC 1468(a) (on transactions with affiliates).

#### National Banks and FSAs

13. Evaluate which acceptances are "ineligible" under the legal lending limits regulation, 12 CFR 32.3(c)(2), and therefore subject to 12 USC 84 and, for FSAs, 12 USC 1464(u).
14. Assess whether all of the bank's own acceptances discounted (purchased), both eligible and ineligible, are booked as loans, making them subject to 12 USC 84 and, for FSAs, 12 USC 1464(u).
15. Assess whether ineligible acceptances are included in the purchasing bank's lending limit to each acceptor bank under 12 USC 84 and, for FSAs, 12 USC 1464(u).

#### **Letters of Credit**

##### National Banks

16. Determine whether the undertakings are independent undertakings pursuant to 12 CFR 7.1016 rather than guarantees under 12 CFR 7.1017. (Updated October 15, 2018)

Confirm that

- independent character of the undertaking is apparent from its terms.
- undertaking is limited in amount.
- bank's undertaking is limited in duration, permits the bank to terminate the undertaking either periodically or at will upon either notice or payment to the beneficiary, or entitles the bank to cash collateral from the account party on demand.
- bank either is fully collateralized or has a post-honor right of reimbursement from its customer or another issuer of an independent undertaking. If the bank's undertaking is to purchase documents of title, confirm that the bank has first priority to realize on the documents if the bank is not otherwise to be reimbursed.

FSA's

17. Determine compliance with 12 CFR 160.50 and 12 CFR 160.120. Assess whether

- independent character of the undertaking is apparent from its terms.
- undertaking is limited in amount.
- undertaking is limited in duration, permits the FSA to terminate the undertaking either periodically or at will upon either notice or payment to the beneficiary, or entitles the FSA to cash collateral from the account party on demand.
- FSA either is fully collateralized or has a post-honor right of reimbursement from its customer or another issuer of an independent undertaking. If the FSA's undertaking is to purchase documents of title, confirm that the FSA has first priority to realize on the documents if the FSA is not otherwise to be reimbursed.
- if the undertaking is to honor by delivery of an item of value other than money, the FSA ensures that market fluctuations that affect the value of the item will not cause the FSA to assume undue market risk.
- if the undertaking provides automatic renewal, the terms for renewal allow the FSA to make any necessary credit assessment before renewal.
- if the FSA issues an undertaking for its own account, the underlying transaction for which it is issued is within the FSA's authority and complies with safety and soundness requirements applicable to that transaction.
- FSA possesses operational expertise that is commensurate with the sophistication of its independent undertaking activities.
- FSA accurately reflects its approved undertakings in its records.

18. Determine compliance with 12 CFR 32.3(d)(1), which permits an FSA with a lending limit calculated under 12 CFR 32.3(a) that is less than \$500,000 to nevertheless have total loans and extension of credit, for any purpose, to one borrower outstanding at one time not to exceed \$500,000.

National Banks and FSA's

19. Determine whether any letters of credit issued on behalf of an affiliate are exempted from 12 USC 371c, 12 USC 371c-1, and 12 CFR 223 (Regulation W).

20. Determine compliance with 12 USC 371c and 12 USC 371c-1 and, for FSA's, 12 USC 371c, 12 USC 371c-1, and 12 USC 1468. Identify any commercial letters of credit that have been drawn upon and for which the bank is not reimbursed on or before the date of payment of the letter of credit. (Note: 12 USC 1468(a)(1)(A) prohibits an FSA from making a loan or extension of credit to any affiliate unless that affiliate is engaged only in activities described in 12 USC 1467a(c)(2)(F)(i)).



21. Determine compliance with lending limits on standby letters of credit under 12 CFR 32.2(g) and 12 CFR 32.3.

- Review letters of credit to determine which are standby letters of credit subject to 12 USC 84 and, for FSAs, 12 USC 84 and 1464(u) (lending limits).
- Determine whether any identified standby letter of credit represents an obligation to the beneficiary on the part of the issuing bank to repay money borrowed by, advanced to, or advanced for the account of the account party; to make payment on account of any indebtedness undertaken by the account party; or to make payment if the account party defaults in the performance of an obligation.
- Determine whether the credit of the account party under any standby letter of credit is analyzed as thoroughly as that of an applicant for an ordinary loan.
- Combine standby letters of credit with any other of the issuing bank's nonaccepted loans to the account party for the purpose of applying 12 USC 84 and, for FSAs, 12 USC 84 and 1464(u).
- Identify standby letters of credit subject to a nonrecourse participation agreement with another bank or banks where the limits of 12 USC 84 and, for FSAs, 12 USC 84 and 1464(u), apply to the issuer and each participant.
- Determine which standby letters of credit are not subject to 12 USC 84 and, for FSAs, 12 USC 84 and 1464(u) because
  - before or at the time of issuance, the issuing bank is paid an amount equal to the bank's maximum liability under the standby letter of credit;
  - before or at the time of issuance, the issuing bank has set aside sufficient funds in a segregated deposit account clearly earmarked to cover the bank's maximum liability under the standby letter of credit; or
  - the OCC has found that a particular standby letter of credit or class of standby letters of credit will not expose the issuer to as much loss as a loan to the account party.

## **Open Accounts**

### National Banks

22. Determine compliance with 12 CFR 7.1020. Assess whether open accounts purchased in connection with export transactions are protected by insurance.

## **Guarantees**

(Updated procedures 23–24 and 26–29 October 15, 2018)

### National Banks

23. Determine whether the bank's obligation is legally a letter of credit or other independent undertaking under 12 CFR 7.1016 or a guarantee under 12 CFR 7.1017.

24. Determine compliance with 12 CFR 7.1017. Ascertain whether

- the bank has a substantial interest in the performance of the transaction involved,
- the transaction is for the benefit of a customer and the bank has obtained from the customer a segregated deposit sufficient to cover the bank's total potential liability, or
- the bank has guaranteed the obligations of a customer, subsidiary, or affiliate that are financial in character, and the amount of the bank's financial obligation is reasonably ascertainable and otherwise consistent with applicable law.

25. Determine compliance with 12 CFR 28.4(c). Assess whether the bank guarantees the deposits and other liabilities of its Edge Act and Agreement corporations and corporate instrumentalities in foreign countries.

26. Determine compliance with 12 USC 604a and 12 CFR 211 (Regulation K). Determine

- whether the guarantee covers transactions permissible under this statute and regulation.
- whether the guarantee or agreement specifies a maximum monetary liability and that outstandings to any one customer do not exceed 15 percent of capital and surplus, unless the bank is fully secured.

27. Determine whether the guarantee is a contractual commitment to advance funds subject to legal lending limits, defined at 12 CFR 32.2(g)(1).

28. Determine compliance with 12 USC 375a, 12 USC 375b, and 12 CFR 215 (Regulation O), for guarantees to executive officers, directors, and principal shareholders.

29. Determine compliance with 12 USC 371c, 12 USC 371c-1, and 12 CFR 223 (Regulation W), for guarantees to affiliates.

### FSAs

30. Determine compliance with 12 CFR 160.60(b). Ascertain whether an FSA that is lending its credit, binding itself as a surety to others, or otherwise guaranteeing,

- has limited its obligation to a fixed dollar amount and a specified duration.
- has a performance obligation under the agreement that creates an authorized loan or other investment.
- is treating its obligation as a loan for the purposes of the legal lending limits, 12 CFR 32, and Regulation O, 12 CFR 215. Regulation O is applicable to FSAs pursuant to 12 CFR 31.2(a).
- is maintaining sufficient perfected security interest in collateral.

31. Determine compliance with 12 USC 371c, 12 USC 371c-1, 12 USC 1468, and 12 CFR 223 (Regulation W), if applicable, for guarantees to affiliates. (Note: 12 USC 1468(a)(1)(A) prohibits an FSA from making a loan or extension of credit to any

affiliate unless that affiliate is engaged only in activities described in 12 USC 1467a(c)(2)(F)(i).

**Objective:** To determine the quantity of liquidity risk associated with trade finance.

1. Determine the volume and growth trend of the banker's acceptance portfolio, including
  - acceptances of nonprime banks.
  - ineligible banker's acceptances.
2. If applicable, determine the volume of trade acceptances.
3. Select a sample of banker's acceptances and verify that
  - ineligible banker's acceptances are properly identified.
  - for national banks, eligible banker's acceptances meet the requirements of section 13 of the Federal Reserve Act (12 USC 372).

**Objective:** To determine the quantity of price risk associated with trade finance.

1. If applicable, determine the implications from foreign currency conversion due to discounting foreign currency denominated drafts or acceptances. Refer to the "Foreign Exchange" booklet of the *Comptroller's Handbook* for guidance. (Procedure updated October 15, 2018)
2. If applicable, consider the implications from foreign currency translation. The examiner should consult with the EIC and examiner assigned to review foreign currency translation bank-wide.

**Objective:** To determine the quantity of interest rate risk associated with trade finance.

1. Determine the tenor of the trade portfolio.
2. Determine the volume and growth trend of longer-term fixed-rate trade transactions.
3. Consult with the EIC and examiner assigned to review bank-wide interest rate risk for adequacy of bank interest rate risk management.

## Quality of Risk Management

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**Conclusion: The quality of risk management is (strong, satisfactory, insufficient, or weak). (Updated October 15, 2018)**

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The conclusion on risk management considers all risks associated with trade finance and services.

### Policies

Policies are statements of actions adopted by a bank to pursue certain objectives. Policies often set standards (on risk tolerances, for example) and should be consistent with the bank's underlying mission, values, and principles. A policy review should always be triggered when the bank's objectives or standards change.

**Objective:** To determine whether the bank has policies that are consistent with safe and sound banking practices and appropriate to the size, nature, and scope of the bank's trade finance and services activities. (Updated objective and procedures 1–4, 6, and 8 October 15, 2018)

1. Evaluate the trade business policy to determine whether it provides appropriate internal bank guidance for managing the bank's trade business and is consistent with the bank's mission, values, and principles. When performing this procedure, consider the following:
  - Consistency with board-approved risk appetite statement and strategic plan.
  - Approved trade products or programs, including participations purchased and sold, third-party guarantee and insurance programs, and guarantees.
  - The role of the trade business unit, e.g., structuring trade transactions, lending authority, country risk analysis and monitoring, relationship monitoring, and policy exception approval.
  - Credit underwriting, analysis, and monitoring standards. As applicable, consult the "Asset-Based Lending," "Commercial Loans," and "Loan Portfolio Management" booklets of the *Comptroller's Handbook* for guidance.
  - Approved risk limits, e.g., customer, country, product or program, and concentration. Refer to the "Concentrations of Credit" booklet of the *Comptroller's Handbook* for guidance.
  - Compliance with laws and regulations
  - Establishment of risk and performance measurement systems (e.g., tenor, concentration, credit risk rating, and return on equity).
  - Reporting to management and the board of directors or their relevant committees.
2. Evaluate the relevant trade operation policies to determine whether they provide appropriate bank guidance consistent with safe and sound banking practices. When performing this analysis, consider the following:

- The role of the trade operation unit, e.g., transaction and payment processing, line limits monitoring, program (e.g., export credit agency) requirements monitoring, exception and past due reporting, complaint and dispute resolution, and collateral monitoring.
  - Requirements for internal control systems (e.g., terminal security, access to processing or funds transfer area, and control over signature list).
  - Prudent actions to take if risk limits are exceeded.
  - Process by which forms and agreements are reviewed by the bank's legal counsel.
  - Accounting and disclosure standards for recording and reporting of the trade business.
  - Establishment of risk and performance measurement systems (e.g., transaction accuracy and timeliness of customer inquiry resolution).
  - Reporting to management and the board of directors or their relevant committees.
3. If the bank is offering new, modified, or expanded products or services (collectively, new activities), determine whether the bank has established an adequate policy for new activity review and approval and has conducted proper due diligence for new trade finance activities. Examiners should consult OCC Bulletin 2017-43, "New, Modified, or Expanded Bank Products and Services: Risk Management Principles," for guidance.
  4. If applicable, determine whether a policy has been established for third-party arrangements. For guidance, see OCC Bulletins 2013-29, 2017-7, and 2017-21.
  5. Verify that the bank has established an effective country risk policy. The examiner should consult with the EIC and the relevant country risk examiner if the bank is subject to an independent country risk management examination. For guidance, see the "Country Risk Management" booklet of the *Comptroller's Handbook*.
  6. Determine whether satisfactory policies for trade finance and services technologies have been established. Policies should exist for meeting Gramm–Leach–Bliley Act information security standards, business continuity planning objectives, and applicable authentication guidelines. See the "Business Continuity Planning" and "Information Security" booklets of the *FFIEC IT Examination Handbook* for guidance. As appropriate, the examiner should consult with the EIC and examiner assigned to review the bank-wide information technology risk.
  7. Verify that policies have been established for BSA/AML and OFAC compliance associated with trade financing. For guidance and examination procedures, see the *FFIEC BSA/AML Examination Manual*. As appropriate, the examiner should discuss with the EIC or examiner assigned to review the bank-wide BSA/AML and OFAC compliance.
  8. As applicable, determine whether the board of directors has adopted policies to control and monitor the foreign-exchange transaction and translation risk arising from discounting foreign-currency denominated drafts and acceptances and foreign operations. The examiners should discuss with the EIC or examiner assigned to review the bank-

wide foreign-exchange risk in making the determination. For guidance on foreign-exchange risk, see the “Foreign Exchange” booklet of the *Comptroller’s Handbook*.

9. Determine whether the board of directors periodically reviews and approves the bank’s trade policies.

## Processes

Processes are the procedures, programs, and practices that impose order on a bank’s pursuit of its objectives. Processes define how daily activities are carried out. Effective processes are consistent with the underlying policies and are governed by appropriate checks and balances (such as internal controls).

**Objective:** To determine whether the bank has processes in place to define how trade finance and services are performed.

1. Evaluate whether the processes are effective, consistent with underlying policies, and effectively communicated to affected staff. Consider
  - whether procedures have been established to implement the trade policies.
  - whether the trade policies are communicated to management and staff in a timely manner.
2. Determine whether the approved products or programs have formal descriptions, are subject to product-level risk assessment, and are consistent with the risk appetite of the board. Review the product description and consider (Updated October 15, 2018)
  - target market, including customers and geographic boundaries.
  - acceptable tenor.
  - product or program risks.
  - risk controls.
  - resources needed.
  - product or program pricing and profitability.
  - transaction approval.
  - exception approval.
3. Determine the effectiveness of processes trade business management use to manage the business. Upon completing a review of the transactions sample (including the associated program or service agreement), provide assessments of
  - appropriateness of deal review (including verification of credit line, compliance with applicable laws and regulations, etc.), credit analysis, and approval processes.
  - appropriateness of the role of trade management in the country risk review process.

- whether the reports management uses for monitoring the trade business are timely and useful (e.g., profitability, volume, trends, limit exception, customer risk rating change, and past-due payments).
  - the adequacy of the process of reporting to the board of directors or its relevant committee.
4. Determine the quality of trade operations processes. Review trade operations procedures and flowcharts, perform walk-throughs, and discuss with operations management to obtain an understanding of the operating environment. Evaluate whether (Updated October 15, 2018)
- adequate controls (e.g., data security, physical access controls, customer authorization, authentication, segregation of duties, and dual controls) have been established for transaction processing. For payment processing, consult the examination procedures contained in the operating procedures, processing, testing, and physical security sections of the “Payment Systems and Funds Transfer Activities” booklet of the *Comptroller’s Handbook*.
  - processes for monitoring and reporting of exceptions (e.g., policy limits) and trade operations performance are done in a timely manner.
  - processes for handling customer complaints and disputes are responsive and timely. Refer also to the “Compliance Management Systems” booklet of the *Comptroller’s Handbook*, which includes information about complaint resolution processes.
  - processes are adequate for
    - assimilating regulatory changes and, as applicable, governing international practices into the systems.
    - validating that forms, agreements, and contracts are reviewed by the bank’s legal counsel.
  - processes controlling the accuracy and completeness of handling documents and instructions are effective. As appropriate, select a sample to test the adequacy of the processes for
    - letters of credit and related products. Consider
      - verification of customer authorization.
      - completeness of documents.
      - timely review of documents after presentation.
      - whether resolution of document discrepancies or a discrepancy waiver is obtained.
      - compliance of payment with terms and conditions of the letter of credit.
      - delivery of banker’s acceptances within the conventional two-day settlement time.
    - advising, collections, and bank-to-bank reimbursement activities. Consider whether
      - instructions are being followed.
      - legal counsel is properly reviewing service contracts and agreements.
      - the bank, through its legal counsel or otherwise, monitors compliance with service contracts.
      - disputes and complaints are properly handled and resolved.

- processes, if applicable, for monitoring compliance with third-party guarantee and insurance program servicing requirements are adequate.
  - processes for monitoring systems capacity and performances are adequate.
  - processes for reporting to management and board are adequate.
5. As applicable, evaluate the quality of the new product review and approval process. At a minimum, consider
    - role of the line of business, treasury, operations, legal, compliance, information technology, finance, accounting, human resources, and audit in the review and approval of new products or programs.
    - whether the relevant risks are identified and implications are adequately analyzed.
    - authorized sign-off.
  6. If applicable, assess whether the process for selecting and monitoring third-party servicers is appropriate. For guidance, see OCC Bulletins 2013-29, 2017-7, and 2017-21. (Updated October 15, 2018)
  7. When evaluating the processes for country risk management, trade loans, and foreign exchange, follow the guidance in the applicable booklets of the *Comptroller's Handbook*: "Country Risk Management," "Commercial Loans," "Accounts Receivable and Inventory Financing," "Asset-Based Lending," "Loan Portfolio Management," and "Foreign Exchange." If the bank is subject to an independent country risk management examination, examiners do not need to perform this procedure relating to evaluating the process for country risk management. For trade loans and foreign exchange, the examiner should consult with the EIC and examiner assigned to review these areas, as appropriate. (Updated October 15, 2018)
  8. Verify that the bank has appropriate procedures in place for managing trade finance and services technology risks. See the relevant *FFIEC IT Examination Handbook* booklet for guidance. As appropriate, the examiner should consult with the EIC and examiner assigned to review the bank-wide information technology risk.
  9. Verify that the bank has appropriate procedures in place for compliance with BSA/AML and OFAC. For guidance and examination procedures, see the *FFIEC BSA/AML Examination Manual*. As appropriate, the examiner should consult with the EIC and the examiner assigned to review the bank-wide BSA/AML and OFAC compliance.
  10. Determine whether appropriate internal controls are in place and functioning as designed. Complete the internal control questionnaire (ICQ) section of this booklet, if necessary, to make this determination.



## Personnel

Personnel are the bank staff and managers who execute or oversee processes. Personnel should be qualified and competent, and should perform appropriately. They should understand the bank's mission, values, principles, policies, and processes. Banks should design compensation programs to attract, develop, and retain qualified personnel. In addition, compensation programs should be structured in a manner that encourages strong risk management practices.

**Objective:** To determine management's ability to supervise trade finance and services in a safe and sound manner.

1. Given the scope and complexity of the bank's trade business, assess the management structure and staffing. Consider the following:
  - Expertise, training, and number of staff members, and whether the staffing and expertise levels are appropriate considering future plans.
  - Level of staff turnover.
  - If applicable, the use of outsourcing arrangements.
  - Whether reporting lines encourage open communication and limit the chances of conflicts of interest.
  - Capability to address identified deficiencies.
  - Responsiveness to regulatory, accounting, industry, and technology changes.
2. Through discussions with management and staff, determine their knowledge of current policies and procedures of the bank's trade business.
3. Determine whether the bank has a training program to develop trade personnel. Consider
  - type, content, and frequency of training.
  - budget allocated to training.
4. Assess performance management and compensation programs. Consider whether these programs measure and reward performance that aligns with the bank's strategic objectives and risk appetite.

If the bank offers incentive compensation programs, determine whether the programs

- provide employees with incentives that appropriately balance risk and reward.
- are compatible with effective controls and risk management.
- are supported by strong corporate governance, including active and effective oversight by the bank's board of directors.

Refer to OCC Bulletin 2010-24, “Interagency Guidance on Sound Incentive Compensation Policies,” for more information regarding sound risk management of incentive compensation programs. (Updated October 15, 2018)

5. If the bank has third-party relationships that involve critical trade finance activities, assess the oversight of such third parties. Refer to OCC Bulletins 2013-29, 2017-7, and 2017-21. (Updated October 15, 2018)

## Control Systems

Control systems are the functions (such as internal and external audits, risk review, and quality assurance) and information systems that bank managers use to measure performance, make decisions about risk, and assess the effectiveness of processes. Control functions should have clear reporting lines, adequate resources, and appropriate authority. Management information systems (MIS) should provide timely, accurate, and relevant feedback.

**Objective:** To determine whether the bank has systems in place to provide accurate and timely assessments of the risks associated with trade finance and services.

1. Determine whether MIS provides timely, accurate, and useful information to evaluate the risk levels, performance, and trends of the trade business. Consider
  - the distribution of MIS reports.
  - the timeliness of MIS reports.
  - the amount and suitability of information provided to management and the board of directors.
2. Assess the scope, frequency, effectiveness, and independence of the internal and external audits of trade finance and services. Consider
  - qualifications of audit personnel, including knowledge of the trade business.
  - access to necessary information and the board of directors.
  - assessment of risk and compliance issues.

Select and complete appropriate examination procedures from the “Internal and External Audits” booklet of the *Comptroller’s Handbook*. As appropriate, coordinate with the examiner responsible for the bank’s audit program.

3. If the bank has a compliance program for the trade business, consider
  - role, responsibilities, and accountability.
  - qualification of compliance personnel, including knowledge of the trade business.
  - communication systems.
4. Evaluate the effectiveness of the monitoring systems to identify, measure, monitor, and control exceptions to policies and established limits.

## Conclusions

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**Conclusion:** The aggregate level of each associated risk is  
(low, moderate, or high).  
The direction of each associated risk is  
(increasing, stable, or decreasing).

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**Objective:** To determine, document, and communicate overall findings and conclusions regarding the examination of trade finance and services.

1. Discuss preliminary examination findings and conclusions with the EIC, including
  - quantity of each associated risk (as noted in the “Introduction” section).
  - quality of risk management.
  - aggregate level and direction of associated risk.
  - overall risk in trade finance and services.
  - violations and other concerns.

<b>Summary of Risks Associated With Trade Finance and Services (Updated October 15, 2018)</b>				
Risk category	Quantity of risk (Low, moderate, high)	Quality of risk management (Weak, insufficient, satisfactory, strong)	Aggregate level of risk (Low, moderate, high)	Direction of risk (Increasing, stable, decreasing)
Credit				
Interest rate				
Liquidity				
Price				
Operational				
Compliance				
Strategic				
Reputation				

2. If substantive safety and soundness concerns remain unresolved that may have a material adverse effect on the bank, further expand the scope of the examination by completing verification procedures.
3. Discuss examination findings with bank management, including violations, deficient practices, and conclusions about risks and risk management practices. If necessary, obtain commitments for corrective action. (Updated October 15, 2018)

4. Compose conclusion comments, highlighting any issues that should be included in the ROE. If necessary, compose matters requiring attention and violation write-ups. (Updated October 15, 2018)
5. Update the OCC's information system and any applicable ROE schedules or tables.
6. Document recommendations for the supervisory strategy (e.g., what the OCC should do in the future to effectively supervise trade finance and services in the bank, including time periods, staffing, and workdays required.) (Updated October 15, 2018)
7. Update, organize, and reference work papers in accordance with OCC policy.
8. Appropriately dispose of or secure any paper or electronic media that contain sensitive bank or customer information. (Updated October 15, 2018)

## Internal Control Questionnaire

An ICQ helps an examiner assess a bank's internal controls for an area. ICQs typically address standard controls that provide day-to-day protection of bank assets and financial records. The examiner decides the extent to which it is necessary to complete or update ICQs during examination planning or after reviewing the findings and conclusions of the core assessment.

For ICQs related to country risk, loan financing, settlement of trade transactions, and foreign exchange examiners should consult the "Country Risk Management," "Accounts Receivable and Inventory Financing," "Asset-Based Lending," "Commercial Loans," "Loan Portfolio Management," "Payment Systems and Funds Transfer Activities," and "Foreign Exchange," booklets of the *Comptroller's Handbook*. (Note: If the bank is subject to an independent country risk management examination, the examiner should perform the ICQ at that examination). (Updated October 15, 2018)

### Banker's Acceptances

#### Policies

1. Determine whether the banker's acceptance policy includes
  - requirements for reviewing banker's acceptance applications.
  - definition of qualified customers.
  - definition of creditworthiness standards of the accepting bank.
  - minimum standards for documentation in accordance with the UCC.

#### Records

2. Is the preparation and posting of subsidiary banker's acceptance records performed or reviewed by persons who do not also
  - issue official checks or drafts singly?
  - handle cash?
3. Are the subsidiary banker's acceptance records balanced daily with the appropriate general ledger accounts, and are reconciling items adequately investigated by persons who do not normally handle acceptances and post records?
4. Are acceptance delinquencies prepared for and reviewed by management on a timely basis?
5. Are inquiries about acceptance balances received and investigated by persons who do not normally handle settlements or post records?

6. Are bookkeeping adjustments checked and approved by an appropriate officer who is independent of preparing the bookkeeping adjustments?
7. Is a daily record maintained summarizing acceptance transaction details (e.g., banker's acceptances created, payments received, and fees collected) to support applicable general ledger account entries?
8. Are acceptances of other banks that have been purchased in the open market segregated on the bank's records from the bank's own acceptances created?
9. Are prepayments (anticipations) on outstanding banker's acceptances netted against the appropriate asset account, "Customer Liability for Acceptances" (or loans and discounts, depending on whether the bank has discounted its own acceptance), and do they continue to be shown as a bank liability, "Acceptances Executed"?
10. Are banker's acceptance records and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record acceptance transactions?

### **Fees**

11. Is the preparation and posting of fees and discounts performed or reviewed by persons who do not also
  - issue official checks or drafts singly?
  - handle cash?
12. Are fee and discount computations adequately tested and compared to initial fee and discount records by persons who do not also
  - issue official checks or drafts singly?
  - handle cash?

### **Other**

13. Are acceptance record copies, own acceptances discounted (purchased), and acceptances of other banks purchased safeguarded during banking hours and locked in the vault overnight?
14. Are blank (pre-signed) customer drafts properly safeguarded?
15. Does an officer approve any acceptance fee rebates?
16. Does the bank have an internal review system that

- reexamines collateral and supporting documentation held for negotiability and proper assignment?
- test-checks values assigned to collateral at frequent intervals?
- determines whether lending officers are periodically advised of maturing banker's acceptances or acceptance lines?

17. Does the bank's acceptance filing system provide for the identification of each acceptance, e.g., by consecutive numbering and applicable letter of credit, to provide a proper audit trail?

### **Conclusion**

18. Based on answers to the foregoing questions, internal control for banker's acceptances is considered (strong, satisfactory, insufficient, or weak). (Updated October 15, 2018)

### **Letters of Credit**

#### **Policies**

1. Determine whether the policy for letters of credit provides appropriate guidance for
  - reviewing letters of credit applications.
  - identifying qualified customers.
  - document reviews.
  - compliance with UCC requirements or the law applicable in the relevant jurisdiction if it differs from the UCC.

#### **Records**

2. Is the preparation and posting of subsidiary letter of credit records performed or reviewed by persons who do not also
  - issue official checks or drafts singly?
  - handle cash?
3. Are the subsidiary letter of credit records (control totals) balanced daily with the appropriate general ledger accounts, and are reconciling items adequately investigated by persons who do not normally handle letters of credit and post records?
4. Are delinquencies arising from the nonpayment of instruments relating to letters of credit prepared for and reviewed by management on a timely basis?
5. Are inquiries regarding letter of credit balances received and investigated by persons who do not normally process documents, handle settlements, or post records?

6. Are bookkeeping adjustments checked and approved by an appropriate officer who is independent of preparing the bookkeeping adjustments?
7. Is a daily record maintained summarizing letter of credit transaction details (e.g., letters of credit issued, payments received, and commissions and fees collected) to support applicable general ledger account entries?
8. Are letter of credit records and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record letter of credit transactions?

### **Commissions**

9. Is the preparation and posting of commission records performed or reviewed by persons who do not also
  - issue official checks or drafts singly?
  - handle cash?
10. Are any independent commission computations adequately tested to initial commission records by persons who do not also
  - issue official checks or drafts singly?
  - handle cash?

### **Documentation**

11. Are terms, dates, weights, descriptions of merchandise, etc., that are shown on invoices, shipping documents, delivery receipts, and bills of lading scrutinized for differences with those detailed in the letters of credit instruments?
12. Are procedures in effect to determine whether
  - the above documents are signed when required?
  - the officer who signed the original letter of credit initials all copies of letters of credit?
  - an officer approves all amendments to letters of credit?

### **Deferred Payment Letters of Credit**

13. Are deferred payment letters of credit
  - recorded as direct liabilities of the bank after it acknowledges receipt of the beneficiary's documents?
  - included in "Other Assets" and "Other Liabilities" in the call report?



**Standby Letters of Credit**

14. Are standby letters of credit segregated or readily identifiable from other types of letters of credit and guarantees?

**Other**

15. Are outstanding letter of credit records and unissued forms safeguarded during banking hours and locked in the vault overnight?

16. Are letters of credit that have been issued with reliance upon a domestic bank, whether on behalf of, at the request of, or under an agency agreement with the domestic bank, recorded as contingent liabilities under the name of that domestic bank?

17. Does an officer approve any commission rebates?

18. Does the bank have an internal review system that

- reexamines collateral items for negotiability and proper assignment?
- test-checks values assigned to collateral when the letter of credit is issued or confirmed and at frequent intervals thereafter?
- determines whether customer payments of letters of credit issued are promptly posted?
- identifies all delinquencies arising from the nonpayment of instruments relating to letters of credit?

19. Are all letters of credit recorded and assigned consecutive numbers?

20. Are lending officers informed of maturing letters of credit and letter of credit lines in a timely manner?

**Conclusion**

21. Based on answers to the foregoing questions, internal control for letters of credit is considered (strong, satisfactory, insufficient, or weak). (Updated October 15, 2018)

**Guarantees****Policies**

1. Determine whether the policy pertaining to guarantees includes

- requirements for reviewing guarantee applications.
- parameters for qualified guarantee account parties.
- review by bank counsel to verify compliance with state law on minimum standards for documentation. (Updated October 15, 2018)

**Records**

2. Is the preparation and posting of subsidiary guarantee records performed or reviewed by persons who do not also
  - issue official checks or drafts singly?
  - handle cash?
3. Are the subsidiary guarantees-issued records balanced daily with the general ledger, and are reconciling items adequately investigated by persons who do not normally handle guarantees?
4. Are guarantee delinquencies prepared for and reviewed by management on a timely basis?
5. Are inquiries regarding guarantee balances received and investigated by persons who do not normally handle guarantees or post records?
6. Are bookkeeping adjustments checked and approved by an appropriate officer who is independent of preparing the bookkeeping adjustments?
7. Is a daily record maintained summarizing guarantee transaction details (e.g., guarantees issued, guarantees canceled or renewed, payments made under guarantees, and fees collected) to support general ledger entries?
8. Are frequent guarantee instrument and liability ledger trial balances prepared, and are they reconciled monthly with control accounts by persons who do not process or record guarantee transactions?

**Guarantee Fees**

9. Is the preparation and posting of fees-collected records performed or reviewed by persons who do not also
  - issue official checks or drafts singly?
  - handle cash?
10. Are fee computations adequately tested and compared to initial fee records by persons who do not also
  - issue official checks or drafts singly?
  - handle cash?

**Other**

11. Are guarantee documents safeguarded during banking hours and locked in the vault overnight?
12. Are all guarantees recorded as liabilities and assigned consecutive numbers?
13. Are all guarantees recorded on individual customer (account party) liability ledgers?

**Conclusion**

14. Based on answers to the foregoing questions, internal control for guarantees is considered (strong, satisfactory, insufficient, or weak). (Updated October 15, 2018)

**Advising****Policies**

1. Determine whether the policy for advising activities addresses (Updated October 15, 2018)
  - legal review of correspondent agreements to assess whether there is clear language covering obligations and fees for advising services.
  - timing requirements for all advised letters of credit.
  - records to be maintained.
  - dispute resolution procedures.

**Records**

2. Are advised letters of credit recorded as memorandum accounts separate from letters of credit issued or confirmed by the bank?
3. Does the bank use standard language to be included on all advised letters of credit clearly defining its advising role?
4. Has bank counsel reviewed the language to be included in advised letters of credit?

**Fees**

5. Has a standard fee schedule for this service been adopted? If not, is the fee schedule identified in the correspondent bank agreement?
6. Is the fee schedule always followed?
7. Is the preparation and posting of fees and discounts performed or reviewed by persons who do not also

- issue official checks or drafts singly?
  - handle cash?
8. Are fee and discount computations adequately tested and compared to initial fee records by persons who do not also
- issue official checks or drafts singly?
  - handle cash?

### **Conclusion**

9. Based on answers to the foregoing questions, internal control for advising is considered (strong, satisfactory, insufficient, or weak). (Updated October 15, 2018)

### **Trade Collections**

#### **Policies**

1. Determine whether the policy for trade collection activities addresses the following:
- Contractual obligations under correspondent agreements
  - Timing requirements for all collections
  - Records to be maintained

#### **Records**

2. Is access to the collection area controlled? (If so, indicate how.)
3. Are permanent registers kept for incoming and outgoing collection items?
4. Are all collections indexed in the collection register?
5. Do such registers furnish a complete history of the origin and final disposition of each collection item?
6. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?
7. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collection items?
8. Is a record kept to show the various collection items that have been paid and credited as a part of the day's business?
9. Is an itemized daily summary made of all collection fees, showing collection numbers and amounts?

10. Is the employee handling collection items required to make settlement on the same business day that payment of the item is received?
11. Have procedures been established, including supervision by an officer, for sending tracers and inquiries on unpaid collection items in the hands of correspondents?
12. In the event of nonpayment of a collection item, is the customer notified and the item promptly returned?
13. Are collection files locked when the employee handling such items is absent?
14. Are vault storage facilities provided for collection items carried over to the next day's business?

### **Fees**

15. Has a standard fee schedule for this service been adopted? If not, is the fee schedule identified in the correspondent bank agreement?
16. Is the fee schedule always followed?
17. Is the preparation and posting of fees and discounts performed or reviewed by persons who do not also
  - issue official checks or drafts singly?
  - handle cash?
18. Are any independent fee and discount computations adequately tested and compared to initial fee records by persons who do not also
  - issue official checks or drafts singly?
  - handle cash?

### **Conclusion**

19. Based on answers to the foregoing questions, internal control for trade collections is considered (strong, satisfactory, insufficient, or weak). (Updated October 15, 2018)

### **Bank-to-Bank Reimbursements**

#### **Policies**

1. Determine whether the policy for bank-to-bank reimbursement services addresses the following:

- Legal review of correspondent agreements to assure clear language related to obligations and fees for the reimbursing services
- Timing requirements for all reimbursements, including any foreign-exchange considerations
- Records to be maintained and accounting treatment for reimbursement and fees earned
- Dispute resolution procedures

### **Records**

2. Has bank counsel reviewed and approved the type and content of the contracts being used?
3. Does the bank have written contracts on hand for each correspondent that clearly defines the functions to be performed by the bank?
4. Is a record kept to show the various items that have been paid and credited as a part of the day's business?
5. Is a record kept to show the source of the exchange rate used to value the reimbursement entries?
6. Is the employee handling the items required to make settlement on the same business day that payment of the item is received?
7. Are instructions for the reimbursement verified before finalizing the accounting entries?

### **Fees**

8. Has a standard fee schedule for this service been adopted? If not, is the fee schedule identified in the correspondent bank agreement?
9. Is the fee schedule always followed?
10. Is the preparation and posting of fees and discounts performed or reviewed by persons who do not also
  - issue official checks or drafts singly?
  - handle cash?
11. Are any independent fee and discount computations adequately tested and compared to initial fee records by persons who do not also
  - issue official checks or drafts singly?
  - handle cash?

**Conclusion**

12. Based on answers to the foregoing questions, internal control for bank-to-bank reimbursements is considered (strong, satisfactory, insufficient, or weak). (Updated October 15, 2018)

**Overall Conclusion**

Based on an aggregate assessment of conclusions for the foregoing activities, internal control for trade finance and services is considered (strong, satisfactory, insufficient, or weak). (Updated October 15, 2018)

## Verification Procedures

Verification procedures are used to verify the existence of assets and liabilities or test the reliability of financial records. Examiners generally do not perform verification procedures as part of a typical examination. Rather, verification procedures are performed when substantive safety and soundness concerns are identified that are not mitigated by the bank's risk management systems and internal controls.

For verification procedures relating to loan financing, settlement of trade transactions, and foreign exchange, examiners should consult the "Accounts Receivable and Inventory Financing," "Asset-Based Lending," "Commercial Loans," "Payment Systems and Funds Transfer Activities," and the "Foreign Exchange" booklets of the *Comptroller's Handbook*. (Updated October 15, 2018)

### Banker's Acceptances

1. Test the additions of the trial balances and their reconciliation to the general ledger.
2. Using an appropriate sampling technique, select banker's acceptances from the trial balances and
  - prepare and mail confirmation forms to
    - account parties for customer liability on acceptances.
    - sellers and purchasers of acceptance and acceptance pool participations.

**Note:** All confirmation forms should be done in the name of the bank, on its letterhead, and returned to its auditing department with a code designed to direct such confirmations, sealed and unopened, to the examiners. Acceptances purchased from other institutions, either whole or in part, should be confirmed only with the selling institution. Acceptances sold to other institutions, whether whole or in part, should be confirmed with the buying institution and the account party.

Account party confirmation forms should include drawer name, date, date of acceptance, maturity date, amount, and related letter of credit number, if applicable. Participations sold or purchased confirmation forms should include purchaser (or seller) name; date participation was sold (purchased); maturity date of participation; whether purchase (or sale) includes all or a portion of a particular acceptance or group of identified or unidentified acceptances; amount(s); fee charged; and whether the purchaser (or seller) has recourse to the bank (or vice versa) in the event of default by the account party, through a repurchase agreement or bank acknowledgment of its liability as guarantor or endorser.

- after a reasonable time, mail second requests.
- follow up on any no-replies or exceptions, and resolve differences.
- examine banker's acceptance record copies and own acceptances purchased for completeness by determining whether they



- are drawn and signed by the party shown as the beneficiary of the letter of credit.
  - are dated.
  - are drawn under the proper letter of credit number.
  - have tenors in accordance with letter of credit terms.
  - are properly endorsed if an endorsement is required.
  - show amounts in figures and words that agree.
  - are drawn on the drawees indicated in the letter of credit.
  - show amounts not exceeding the balance available under the letter of credit.
  - indicate amounts equal to the total value of the respective invoices unless otherwise stipulated in the terms, e.g., drafts for 70 percent of invoice value.
  - have no restrictive endorsements such as “for deposit only” if the acceptance is to be discounted.
  - do not include the words “without recourse” with regard to either the drawer or endorsers.
- check that the required initials of the approving officer are on the acceptance.
  - check that the acceptance is signed, appears to be genuine, and is negotiable.
  - compare collateral, e.g., trust receipts and warehouse receipts, with the description on the collateral records.
  - check that procedures are in effect to preclude a customer from obtaining additional credit extensions on the same merchandise.
  - determine whether the proper assignments, hypothecation agreements, security agreements, etc., are on file.
  - test the pricing of negotiable collateral, if any.
  - determine whether collateral margins are reasonable and in line with bank policy and legal requirements.
  - list all collateral discrepancies and investigate.
  - determine whether any collateral is held by an outside custodian or has been temporarily removed for any reason.
  - forward a confirmation request on any collateral held outside the bank. (Confirmation forms should be prepared in the name of the bank, on its letterhead, and returned to its auditing department with a code designed to direct such confirmations to the examiners.)
  - determine whether each file contains documentation supporting guarantees and subordination agreements, when appropriate.
  - determine whether any required insurance coverage is adequate and whether the bank is named as loss payee.
  - review banker’s acceptance participation agreements, taking extracts when necessary for such items as rate of service fee, interest rate, and remittance requirements, and determine whether customer has complied.
  - review ledgers and authorizations and determine whether authorizations are signed in accordance with terms of the acceptance agreements.

3. Review acceptance fees, discount charges, and brokerage fees relating to own acceptances rediscounted and acceptances of other banks purchased by
  - reviewing and testing procedures for accounting for acceptance fees, discount charges, and brokerage fees, and for handling of adjustments.
  - scanning for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.

## Letters of Credit

1. Test the addition of the trial balances and the reconciliation of the trial balances to the general ledger.
2. Using an appropriate sampling technique, select letters of credit from the trial balance and
  - prepare and mail confirmation forms to account parties of letters of credit issued (exclude confirmed letters of credit, which are covered in the fourth bullet below).

**Note:** Letter of credit participations serviced by other institutions should be confirmed only with the servicing institution. Letter of credit participations serviced for other institutions should be confirmed with the buying (participating) institution and the account party. Confirmation forms should be done in the name of the bank and on its letterhead, and returned to its auditing department with a code designed to direct such confirmations, sealed and unopened, to the examiners. Confirmation forms should include account party, letter of credit number, amount, commission charged, and brief description of collateral, if any.

- after a reasonable time, mail second requests.
- follow up on any no-replies or exceptions, and resolve differences.
- determine whether the bank's confirmation forms agree with incoming authenticated message and subsequent written follow-up instructions from the issuing bank.
- examine letters of credit and accompanying documentation for completeness by determining
  - whether they are supported by the required application with officer approval.
  - whether all the documents listed in the covering letter have been received and whether the letter of credit relates to the draft and documents submitted. Check the letter of credit number of draft.
  - whether the letter of credit has expired or been canceled.
  - whether the available balance of the letter of credit is sufficient to cover the draft amount.
  - whether the exporter is making partial shipments when the letter of credit allows only one shipment to be made for the full amount.
  - whether the beneficiary of two letters of credit combines the shipment and presents only one set of documents.
  - whether the bill of lading is a straight or order instrument.

- whether the bill of lading is endorsed to the bank.
  - whether the bill of lading is “foul” or “on deck,” unless specifically allowed.
  - whether the commercial invoice exceeds the amount available under the letter of credit.
  - whether the weight list detailing each shipping container and its weight certificate stipulating the weight of the merchandise as a whole is signed and agrees with amounts shown on other documents.
  - whether there is a copy of the packing list for each copy of the merchandise invoice.
  - whether the insurance policy or certificate is properly endorsed and covers the specific risks enumerated in the letter of credit, whether the amounts are correct, and whether the description of the goods conforms to that on the letter of credit.
  - whether the inspection certificate attesting to the quality, quantity, and condition of the merchandise is the same on all other documents.
  - whether the information on the certificate of origin agrees with the requirements of the letter of credit.
  - whether any required consular invoices are present.
- check whether the required authorized signature of an approving officer is on each letter of credit form, whether issued or confirmed.
  - check whether the letter of credit issued appears to be genuine.
  - determine whether proper assignments, hypothecation agreements, etc., are on file.
  - test the pricing of any negotiable collateral.
  - determine that collateral margins are reasonable and in line with bank policy and legal requirements.
  - list all collateral and documentation discrepancies, and investigate.
  - determine if any collateral is held by an outside custodian or has been temporarily removed for any reason.
  - forward a confirmation request on any collateral held outside the bank. (Confirmation forms sent should be done in the name of the bank and on its letterhead, and returned to its auditing department with a code designed to direct such confirmations to the examiners.)
  - determine that each file contains documentation supporting counter-guarantees or letters of credit, when appropriate.
  - review letter of credit participation agreements, taking extracts when necessary for such items as rate of service fee, interest rate, and remittance requirements, and determine compliance.
  - review customer ledgers to determine compliance with line authorizations and letter of credit agreement terms.
3. Review the commission accounts relating to issuing, amending, confirming, and negotiating letters of credit by
- reviewing and testing procedures for accounting for commissions and the handling of adjustments.

- scanning commissions for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.

## Guarantees

1. Test the addition of trial balances and their reconciliation to the general ledger.
2. Using an appropriate sampling technique, select guarantees issued from the trial balance and
  - prepare and mail confirmation forms to account parties. All confirmation forms should be done in the name of the bank and on its letterhead, and returned to its auditing department with a code designed to direct such confirmations, sealed and unopened, to the examiners. Guarantees serviced by other institutions, either whole guarantees or syndicate participations, should be confirmed only with the servicing institution (or lead bank). Guarantees serviced for other institutions, either whole guarantees or syndicate participations, should be confirmed with the buying institution and the account party. Confirmation forms should include the account party's name, guarantee number, amount, fee charged, and a brief description of any collateral or counter-guarantee held.
  - after a reasonable time, mail second requests.
  - follow up on any no-replies or exceptions, and resolve differences.
  - examine the guarantee documents for completeness, and agree on date, amount, and terms to the trial balance.
  - in the event any guarantees issued are not held at the bank, request confirmation from the holder.
  - check whether required initials of the approving officer are on the guarantee instrument.
  - check whether the signature on the guarantee is authorized.
  - compare any collateral held with the description on the collateral register.
  - determine whether the proper assignments, hypothecation agreements, etc., are on file.
  - test the pricing of any negotiable collateral.
  - determine whether collateral margins are reasonable and in line with bank policy and legal requirements.
  - list all collateral discrepancies and investigate.
  - determine whether any collateral is held by an outside custodian or has been temporarily removed for any reason.
  - forward a confirmation request on any collateral held outside the bank. (Confirmation forms sent should be done in the name of the bank and on its letterhead, and returned to its auditing department with a code designed to direct such confirmations, sealed and unopened, to the examiners.)
  - determine whether each file contains documentation supporting counter-guarantees, if applicable.

- review guarantee participation agreements, taking extracts when necessary for such items as fees charged the account party or remittance requirements, and determine whether the account party has complied.
  - if the bank has to pay a beneficiary under its guarantee, review disbursement ledgers and authorizations to determine whether payment was effected in accordance with the terms of the guarantee agreement.
3. Review fees-collected accounts by
- reviewing and testing procedures for accounting for fees collected and for handling any adjustments.
  - scanning fees collected for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.

### Advising

1. Test the addition of trial balances and their reconciliation to the general ledger memorandum accounts.
2. Using an appropriate sampling technique, select advised letters of credit from the trial balance and
  - prepare and mail confirmation forms to account parties. (All confirmation forms should be done in the name of the bank and on its letterhead, and returned to its auditing department with a code designed to direct such confirmations, sealed and unopened, to the examiners.)
  - after a reasonable time, mail second requests.
  - follow up on any no-replies or exceptions, and resolve differences.
  - examine advised letters of credit for completeness, verify that appropriate legal language is included that limits the bank's liability to an advising capacity, and agree on date, amount, and terms to the trial balance.
3. Review fees-collected accounts by
  - reviewing and testing procedures for accounting for fees collected and for handling any adjustments.
  - scanning fees collected for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.

### Trade Collections

1. In the event that memorandum control accounts are maintained, prepare or request that the bank prepare, under your supervision, a trial balance of each account controlled.
2. In the case of unusual, altered, or longstanding items, prepare and mail confirmation requests to customers. (Confirmation forms sent should be done in the name of the bank

and on its letterhead, and returned to its auditing department with a code designed to direct such confirmations, sealed and unopened, to the examiners.)

3. Using an appropriate sampling technique, select representative items and
  - review all supporting documents.
  - review the authenticity of each item selected, and trace and clear each item through final payment, including the posting of the appropriate credit to the customer.
4. Test postings of collections on detailed records to determine whether disbursement of funds collected is in accordance with customers' instructions.
5. Determine whether credit is given promptly, on the same day received, for all collections settled.
6. Test appropriate records to determine whether collection of fees for this service is in accordance with established policies or practices and whether bank income accounts are being credited on a daily basis.

### **Bank-to-Bank Reimbursements**

1. Test the addition of trial balances and their reconciliation to the general ledger.
2. Using an appropriate sampling technique, select reimbursement items from the trial balance and
  - prepare and mail confirmation forms to account parties. (All confirmation forms should be done in the name of the bank and on its letterhead, and returned to its auditing department with a code designed to direct such confirmations, sealed and unopened, to the examiners.)
  - after a reasonable time, mail second requests.
  - follow up on any no-replies or exceptions, and resolve differences.
3. Review fees-collected accounts by
  - reviewing and testing procedures for accounting for fees collected and for handling any adjustments.
  - scanning fees collected for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.

# Appendixes

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## Appendix A: Commercial Documentary Letter of Credit

### Overview

A letter of credit is an instrument through which a bank furnishes its credit in place of its customer's credit. The bank plays an intermediary role to help complete the transaction. There are three parties to a letter of credit: the account party (or buyer), the beneficiary (the seller), and the bank. Generally, a letter of credit also identifies a paying bank.

A commercial letter of credit is a letter addressed by a bank (issuing bank) on behalf of the bank's customer—a buyer of merchandise—to a seller authorizing the seller to draw drafts up to a stipulated amount under specified terms and undertaking to provide eventual payment for drafts drawn. The seller is paid when the terms of the letter of credit are met and the required documents are submitted to the issuing bank. (See appendix C for additional information on the process flow for issuing a commercial letter of credit.)

Commercial letters of credit are issued in either irrevocable or revocable form. An irrevocable letter of credit is a definite commitment by the issuing bank to pay, provided the seller complies with the letter's terms and conditions. An irrevocable letter of credit cannot be changed without the consent of all parties. Conversely, a revocable letter of credit can be canceled or amended by the issuing bank without notice to the seller. The revocable letter of credit is not truly a bank credit but serves as a means by which the buyer and seller settle payments. Because a revocable credit can be canceled or changed without notice, the seller should rely not on the credit but on the willingness and ability of the buyer to meet the terms of the underlying contract. The revocable letter of credit is not a commonly used instrument.

The letter of credit may be sent to the seller directly by the issuing bank or through the issuing bank's correspondent in the same country as the beneficiary. The correspondent may act as an "advising bank." Advised letters of credit bear a notation by the advising bank that it makes "no engagement," or words to that effect. An irrevocable advised letter of credit is, therefore, the undertaking of the issuing bank to pay rather than that of the advising bank.

Some sellers, particularly those not familiar with the issuing bank, ask the buyer to have the irrevocable letter of credit issued in the buyer's country and "confirmed" by a bank in the seller's country. Confirmed letters of credit bear the confirming bank's declaration, "We undertake that all drafts drawn ... will be honored by us," or a similar statement. Because the seller of a confirmed credit has a definite commitment to pay from a bank in its country, it does not need to be concerned with the willingness or ability of the issuing bank to pay. A bank may play more than one role. For example, an advising bank may add its confirmation and be designated in the letter of credit as the paying bank.

Payment terms of a commercial letter of credit generally vary from "at sight" to 180 days, although other terms are sometimes used. The letter specifies on which bank the drafts are to

be drawn. If the draft is drawn at sight, the bank makes the payment upon presentation of the draft, provided the terms of the credit have been met. If the draft is to be drawn at maturity, the bank accepts the draft (by stamping “accepted” on its face) and holds it until it is payable. Alternatively, the seller can hold the draft, or the bank or the seller can sell or discount it. (For additional information, see “Banker’s Acceptances” in appendix B.)

If, after the letter of credit has been received, the seller finds that some of its terms or conditions are unacceptable, she or he may contact the buyer to arrange for an amendment. The buyer then requests the issuing bank to issue an amendment. If the terms of the amendment restrict, contradict, or alter the value or terms of the letter of credit in any way, the seller must grant his or her approval before the amendment can be considered.

In letter of credit transactions, the bank takes an active role in the exchange of documents between buyer and seller. These documents are the means by which the banker participates in the trade transaction, either as agent for the seller or financier for the buyer.

## Documents

The success of a commercial letter of credit transaction depends heavily on documentation, and a single transaction can require many different kinds of documents. Most letter of credit transactions involve a draft, an invoice, an insurance certificate, and a bill of lading. Governments regulating the passage of goods across their borders may require inspection certificates, consular invoices, or certificates of origin. Because letter of credit transactions can be complicated and can involve many participants (not to mention different divisions within the bank), it is important for banks to verify that their letters are accompanied by the proper documents, that those documents are accurate, and that all areas of the bank handle them properly. (Updated October 15, 2018)

Documentation is of four primary types: transport, insurance, commercial, and other. Transport documents are issued by a transportation company when moving the merchandise from the seller to the buyer. The bill of lading is the most common transfer document.

- The bill of lading is a receipt given by the freight company to the shipper. A bill of lading serves as a document of title and specifies who is to receive the merchandise at the designated port (as specified by the exporter). It can be in nonnegotiable form (straight bill of lading) or in negotiable form (order bill of lading). In a straight bill of lading, the seller consigns the goods directly to the buyer. This type of bill usually is not desirable in a letter of credit transaction, because it allows the buyer to obtain possession of the merchandise without regard to any bank agreement for repayment. A straight bill of lading may be more suitable for prepaid or open account transactions.

With an order bill of lading, the shipper can consign the goods to the bank, which retains title until the buyer acknowledges liability to pay. This method is preferred in commercial letter of credit transactions. The bank maintains control of the merchandise until the buyer completes all the required documentation. The bank then releases the bill of lading



to the buyer, who presents it to the shipping company and gains possession of the merchandise.

- Insurance documents, normally an insurance certificate, cover the merchandise being shipped against damage or loss. The terms of the merchandise contract may dictate that either the seller or the buyer obtain insurance. Open policies may cover all shipments and provide for certificates on specific shipments.

In financing shipments of goods, there is always the risk that a shipment will be damaged or destroyed, the wrong goods will be shipped, or the quality of goods (especially if the goods are agricultural) will be lower than stipulated. Insurance coverage is crucial to protect the buyer, the seller, and the bank from financial loss. Banks should not issue commercial letters of credit without satisfactory insurance coverage on the merchandise being shipped, when applicable.

- The commercial documents, principally the invoice, are the seller's description of the goods shipped and the means by which the buyer gains assurances that the goods shipped are the same as those ordered. Among the most important commercial documents are the invoice and the draft or bill of exchange. Through the invoice, the seller presents to the buyer a statement describing what has been sold, the price, and other pertinent details.

The draft supplements the invoice as the means by which the seller charges the buyer for the merchandise and demands payment from the buyer, the buyer's bank, or some other bank. Although a draft and a check are very similar, the writer of a draft demands payment from another party's account. In a commercial letter of credit, the draft is drawn by the seller, usually on the issuing, confirming, or paying bank, for the amount due under the terms of the letter of credit. In a collection, this demand for payment is drawn on the buyer. The customary parties to a draft, which is a negotiable instrument, are the drawer (usually the seller), the drawee (the buyer or a bank), and the payee (usually the seller), who is also the endorser. A draft can be "clean" (an order to pay) or "documentary" (with shipping documents attached).

A draft that is negotiable<sup>15</sup>

- is signed by the maker or drawer;
- contains an unconditional promise or order to pay a certain sum of money;
- is payable on demand or at a definite time;
- is payable to order or to bearer; and
- may be sold and ownership transferred by endorsement, assuming certain conditions are met, to a "holder in due course." The holder in due course has recourse to all previous endorsers if the primary obligor (drawee) does not pay. The seller (drawer) is the secondary obligor if the endorser does not pay. The secondary obligor has an unconditional obligation to pay if the primary obligor and the endorser do not, therefore the term "two-name paper."

<sup>15</sup> Refer to UCC article 3, "Negotiable Instruments."

- Other documentation includes certain official documents that may be required by governments to regulate and control the passage of goods through their borders.

## Document Discrepancies

Document discrepancies can range from minor typographical errors to misstatements or incorrect documents. When a bank discovers such errors, especially material discrepancies, it should notify all parties and amend the documents. If the bank does not do so, it stands to lose protection and rights. Ultimately, it is the account party's right to decide whether to accept the documents with discrepancies or to delay or even cancel the transaction. The table below highlights some of the common errors found on commercial letters of credit documents.

Trade transactions usually require “clean” bills of lading, which bear no notation or clause across the face indicating any damages or irregularities in the goods or the packaging of the goods. If a bill of lading bears such notation or clause, it is called a “foul” or “unclean” bill of lading. Unless specifically stated otherwise, all bills of lading tendered under credits must be “order” bills as opposed to “straight” bills.

Common Errors in Documentation of Letters of Credit	
Bills of Lading	Invoices
<ul style="list-style-type: none"> <li>• It is unclean.</li> <li>• Ports are different from those in the letter of credit terms.</li> <li>• It does not indicate whether freight is prepaid.</li> <li>• There is a later date of shipment than that allowed by terms of the letter of credit.</li> <li>• Description of merchandise is inconsistent with other documents.</li> </ul>	<ul style="list-style-type: none"> <li>• Invoice name and address do not agree with letter of credit.</li> <li>• Quantity does not agree with other supporting documents.</li> <li>• Unit price or extensions of unit price are incorrect.</li> <li>• Certification required by letter of credit terms is missing.</li> <li>• Contains excess shipment, short shipment, or partial shipment, which may be prohibited by letter's terms.</li> <li>• Adjustments on previous shipments or charges that are not allowed under the letter's terms are shown.</li> <li>• Sales terms are omitted or incorrect.</li> </ul>
Insurance Documents	Drafts and Other Documents
<ul style="list-style-type: none"> <li>• Coverage differs from that required by letter of credit terms.</li> <li>• Claims are payable in currency other than stipulated in letter of credit.</li> <li>• Policy does not cover transfer between shippers, although bills of lading show the transfer will take place.</li> <li>• Insurance certificate is presented instead of policy, when policy is required.</li> <li>• Merchandise description is inconsistent with other documents.</li> </ul>	<ul style="list-style-type: none"> <li>• Draft is drawn to purchaser instead of issuing bank.</li> <li>• Drawer's name does not correspond to name on invoice.</li> <li>• Tenor of draft differs from that of the letter of credit.</li> <li>• Credit amount is disproportionate to quantity invoiced.</li> <li>• Certificates of origin do not comply with the requirements set forth in the letter of credit.</li> </ul>

## Appendix B: Banker's Acceptances

Most banker's acceptances arise from international trade transactions. These banker's acceptances are eligible for discount at the Federal Reserve Banks if the acceptances meet the requirements of section 13 of the Federal Reserve Act of 1913, as amended.<sup>16</sup>

### Eligible Acceptances

Any Federal Reserve Bank may discount acceptances if the acceptances meet the following criteria:

- Acceptance must grow out of a transaction involving the import or export of goods or a transaction involving the domestic shipment of goods, or be secured at the time of the acceptance by a warehouse receipt or similar document conveying or securing title covering readily marketable staples.
- Acceptance must be endorsed by at least one member bank.
- Remaining maturity of the acceptance, excluding days of grace, must not exceed 90 days, with an exception that such acceptances, if drawn for an agricultural purpose and secured at the time of acceptance by warehouse receipts or other such documents conveying or securing title covering readily marketable staples, may be discounted with a maturity at the time of discount of not more than six months, excluding days of grace.<sup>17</sup>

Banker's acceptances that satisfy all of these criteria are exempt from the Federal Reserve's reserve requirements because they are not considered "deposits" for this purpose<sup>18</sup> and are also exempt from federal lending limits.<sup>19</sup>

### Limitations

12 USC 372<sup>20</sup> generally limits the total amount of eligible banker's acceptances that a national bank can accept from any one party to 10 percent of the bank's capital and surplus;<sup>21</sup> limits the total amount of drafts of all types that a national bank can accept from all parties combined to 150 percent of the bank's capital and surplus (unless it receives permission from

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<sup>16</sup> Because there is now an active secondary market for "eligible" banker's acceptances, the role of the Federal Reserve Banks in purchasing banker's acceptances has diminished.

<sup>17</sup> 12 USC 346 and 372.

<sup>18</sup> 12 CFR 204.2(a)(1)(vii)(E).

<sup>19</sup> 12 USC 84(c)(2) and 12 CFR 32.3(c)(2).

<sup>20</sup> This statute does not apply to FSAs.

<sup>21</sup> 12 USC 372(e).

the Federal Reserve Board to raise that figure to 200 percent);<sup>22</sup> and limits the aggregate amount of drafts arising out of domestic transactions to 50 percent of the total of all acceptances.<sup>23</sup> The limitations do not apply to that portion of an acceptance covered by a participation agreement sold between the creating bank and the participating bank.<sup>24</sup>

FSAs also can purchase banker's acceptances, subject to 12 USC 1464(c)(1)(M) and 12 CFR 160.30. While the statutory scheme for FSAs does not impose a set limit, OCC regulations state that the OCC "may establish an individual limit on such loans or investments if the association's concentration in such loans or investments presents a safety and soundness concern."<sup>25</sup>

## Financing Through Discounting Banker's Acceptances

After the time draft has been "accepted" by a bank, the exporter holding the acceptance might desire funds before the acceptance matures. In this case, the exporter would sell the acceptance at a discount. Banks mostly discount their own acceptances, but they also discount acceptances of other prime banks. On occasion, to accommodate a customer, a bank may discount the acceptance of a nonprime bank or trade acceptance. A bank, once it has accepted (discounted) a draft, can hold the paper until maturity or sell (rediscount) it in the secondary market, either directly or through a dealer.

Banker's acceptances are a relatively secure investment to the investor because of the two-name backing, which means the importer is secondarily liable on the instrument. In addition, the instrument is a contingent obligation of the drawer (exporter). In other words, the exporter is contingently liable if the importer does not pay. The acceptance is also an obligation of any other institutions that have endorsed the instrument. Major investors in banker's acceptances are other banks, foreign central banks, money market funds, corporations, and other domestic and foreign institutional investors.

Since banker's acceptances are tied to a specific trade transaction, it is possible for the underlying transaction to be completed before the acceptance used to finance the transaction matures. An importer, for instance, may be able to sell the goods and receive the proceeds well before the acceptance matures. In such cases, most banks require the customer to prepay the banker's acceptance. Since banks generally are willing to refund a portion of the discount charges in the case of prepayments, the importer saves some expenses. Prepayment also provides a control to prevent the proceeds of a bank-financed transaction from being diverted to speculative or unauthorized activities. (Updated October 15, 2018)

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<sup>22</sup> 12 USC 372(b) and (c). For a federal branch or agency, the limit would be the dollar equivalent as determined by the Federal Reserve Board under 12 USC 372(h).

<sup>23</sup> 12 USC 372(d).

<sup>24</sup> 12 USC 372(f).

<sup>25</sup> 12 CFR 160.30, footnote 6.

Even though a bank's customer may be required to prepay a banker's acceptance, a bank can never prepay or extinguish its own acceptance liability before maturity.

## Secondary Market for Banker's Acceptances

When banks sell banker's acceptances, they use the services of banker's acceptance dealers and brokers or they go directly to investors.

Banker's acceptances are not traded on an organized exchange, but a secondary market exists for the acceptances of larger, well-known banks (quotes are available from most securities dealers). Average banker's acceptance yields are published in financial newspapers such as *The Wall Street Journal*. Since banker's acceptances are the obligation of the accepting bank, they are traded on the basis of the bank's credit standing. Investors use a tiered approach to pricing that reflects an assessment of the bank's credit standing rather than the class of the bank, e.g., whether it is a money market bank, a Japanese bank, or a Yankee issuer (U.S. dollar acceptances created by foreign banks).

Banker's acceptances are quoted, bought, and sold on a discounted basis similar to U.S. Treasury bills and commercial paper. Dealers and brokers in New York and other money centers offer discount rates. Some dealers post bid and ask rates, but most trading is done on a negotiated basis. The yields of certain large U.S. banks are quoted as "a run" from one to six months. Banker's acceptances of "second-tier" banks, Edge Act corporations, and foreign banks trade "off the run" (at higher rates).

Brokers do not buy banker's acceptances for their own account. Instead, they purchase them for resale to investors. Quoted rates reflect an assessment of the underlying draft, which can reflect a number of variables, including the perceived credit strength of the bank; the volume of acceptances the bank offers the market; and the amount, tenor, and delivery date of the draft.

Most institutional portfolio managers (and most individual investors) who invest in banker's acceptances are name-conscious, and, as a result, their assessment of a bank's creditworthiness can vary significantly depending on the market's recognition of a bank. In addition, they usually undertake a formal review to develop a list of acceptable banks in whose paper they will invest. Because the strong credits are favored, the resulting demand for their paper gives them a cost advantage over weaker banks.

The amount of acceptances issued by a bank into the market also influences pricing. Investors frequently go to the trouble of qualifying a bank's name only if the bank provides substantial paper to the market. Banks with lower volumes may experience a thinner market and thus incur a cost premium because their banker's acceptances trade at a higher yield (lower net proceeds upon sale) in the secondary market.

The dollar amount of drafts offered to the market is also important, with investors generally favoring large transactions of \$1 million or more. Smaller acceptances and odd amounts can

incur a price disadvantage. Banker's acceptances with maturities shorter than 30 days also generally incur a price disadvantage.

The operational ability of a bank to make timely delivery to the broker of the drafts is important in the secondary market because the broker needs to sell and deliver the acceptances to investors as soon as possible. Convention calls for delivery of drafts and settlement two days after the dealing date. The bank must be able to deliver on the settlement date.

Bank money managers do not have to sell all banker's acceptances through money center brokers. Frequently, managers can sell their banker's acceptances locally at a lower yield, which increases the sale proceeds. This transaction often is possible when investors are already accustomed to purchasing the bank's certificates of deposit or other investments. The bank's trading, trust, or treasury departments can easily contact local investors without using a broker as an intermediary, thereby reducing cost. Local investors are also more likely to be interested in smaller transactions. Local rediscounting, however, probably best serves to complement rather than replace the broker market because local markets tend to be thin and do not absorb a high volume of paper at the most competitive rates.

## **Characteristics of Banker's Acceptances**

### **Credit Quality**

An acceptance's credit quality depends on the method by which the bank acquired the acceptance and the acceptance's terms. For an accepting bank, the credit quality is that of the customer whose transaction the bank is financing. The credit quality of a banker's acceptance may differ from a direct loan depending on the terms and conditions of the two instruments.

When the bank purchases an acceptance in the market, the credit quality is that of the "accepting" bank whose acceptance the bank purchases. Credit quality is also enhanced by the fact that the holder of a banker's acceptance has secondary recourse to the account party (importer/buyer) if the accepting bank defaults.

### **Marketability**

Banker's acceptances are marketable, short-term investment instruments that are traded actively by banks, brokers, and other institutional investors. Many institutional investors buy and sell banker's acceptances for their own accounts and for various funds they have established for their customers.

Generally, local investors do not demand the high yields of institutional investors. This increases the bank's acceptance fee when dealing with local investors. Banker's acceptance rates are based on markets that may move rapidly in a very short time. It is crucial that rates on acceptance financing are available on a timely basis because these instruments have become increasingly volatile. For example, a quote made at 9:30 a.m. may not reflect the market even an hour later. If rates have moved up significantly in that hour, the bank may

lose its entire acceptance commission as the funding cost rises. If rates fall during that hour, another bank will almost certainly get the business by lowering its quote.

**Liquidity**

Banker's acceptances often are structured to mature in six months or less. Banks can purchase, discount, and sell the acceptances of other banks as short-term, money market assets (with low risk). Should a bank need to obtain funds, the banker's acceptances can readily be sold at a predictable price as long as credit quality has not changed.

## Appendix C: Issuance of Commercial Letter of Credit and Banker's Acceptance

The process described below and the diagram that follows provide an example of a trade transaction creating a commercial letter of credit and a banker's acceptance. The numbers in parentheses refer to the steps in the diagram. In addition, a more detailed explanation of the different roles that a bank may take in a commercial letter of credit transaction is provided at the end of this section.

### Process

NE Trading is interested in purchasing 20 personal computers from Tokyo Tech (1). Because the two companies have never done business with each other, Tokyo Tech requires that NE Trading obtain a commercial letter of credit. The letter of credit places the bank in the intermediary role to facilitate the transaction's completion.

NE Trading takes the computer purchase contract to its bank, FNB, and completes an application for a commercial letter of credit (2). FNB opens the letter of credit and sends the original and a copy to Tokyo Tech's bank, Suki Bank (3). Tokyo Tech is not familiar with FNB, so it pays a fee to have Suki Bank confirm the letter of credit, which makes Suki Bank liable should NE Trading and FNB fail to perform under the letter of credit. Suki Bank staff members verify the letter of credit and notify Tokyo Tech of its validity (4).

Tokyo Tech ships the goods to NE Trading (5) and presents the shipping documents to Suki Bank (6) to have them negotiated. Along with the documents is a draft, drawn on FNB, for the selling price of the goods. This example uses a time (90 days) draft. The terms of the draft were negotiated when the terms of the letter of credit were determined. Suki Bank examines the documents and, if they meet the terms and conditions of the letter of credit, sends the draft and the shipping documents to FNB (7). Had it been a sight draft, Suki bank would have made payment of the invoice amount to Tokyo Tech and mailed the draft and documents to FNB, requesting that its account be credited for the amount paid.

FNB compares the documents with the letter of credit to verify that they meet the letter's terms and conditions. If all is in order, FNB gives NE Trading the documents (8) and an advice of amount paid, and notifies Suki Bank that it "accepts" the draft (9). The term "accepted" is stamped on the face of the draft, thus creating a banker's acceptance. If NE Trading were a large corporation with a market name, it could accept the draft itself without requiring FNB to accept, creating a trade acceptance. (Updated October 15, 2018)

By accepting the draft, FNB has accepted Tokyo Tech's demand for payment and has committed to paying Tokyo Tech in 90 days. The accepted draft is then sent to Tokyo Tech, through Suki Bank (10). As part of the letter of credit agreement, NE Trading is required to pay FNB within 90 days (11). FNB then uses those funds to pay Tokyo Tech, through Suki Bank (12, 13).



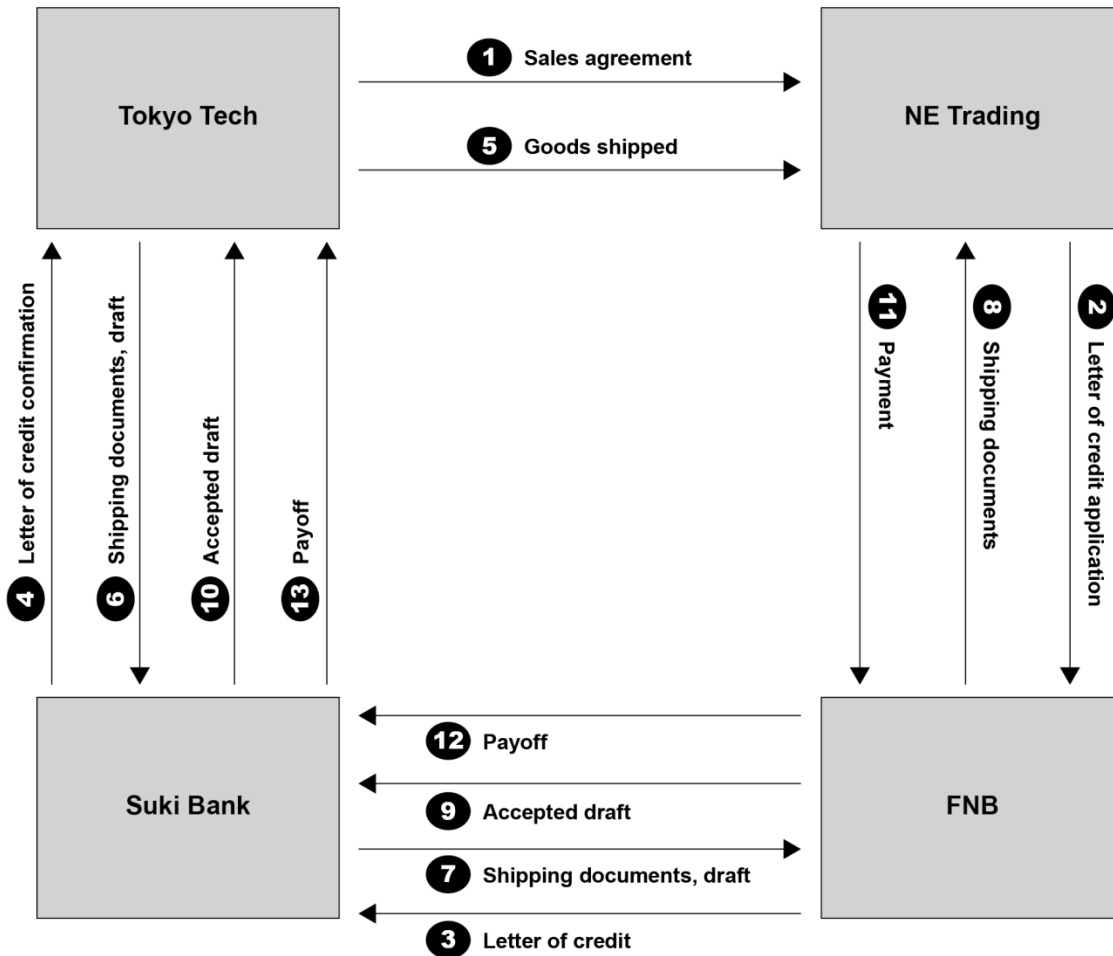
Tokyo Tech may hold the acceptance until maturity and present it to FNB for payment, or it may obtain immediate cash by selling the acceptance to an investor, perhaps to FNB or Suki Bank. In the latter case, Suki Bank would then present the acceptance at maturity to FNB for repayment.

When FNB accepted the draft in the example, it acquired an unconditional obligation to pay at maturity a specified amount, either to Tokyo Tech or to the holder of the instrument if Tokyo Tech discounted the acceptance. If discounted, Tokyo Tech would remain secondarily liable to the holder (purchaser or discounter) of the acceptance in the event of default by FNB.

If FNB purchases (discounts) its own acceptance, it may elect to hold the acceptance in its own portfolio. In this event, the acceptance is recorded as a loan to NE Trading and must be funded like any other loan. More commonly, however, the bank will choose to replenish its funds by selling (rediscounting) the acceptance in the secondary market, either directly or through a dealer. If the banker's acceptance is not held in portfolio, the bank records its obligation as "acceptances executed."

When an acceptance is sold, ownership is transferred by endorsement to another party termed "holder in due course." The holder in due course has recourse to all previous endorsers if the bank creating the acceptance does not pay. The secondary obligor (payee on draft) has an unconditional obligation to pay if the accepting bank and endorsers do not, hence the term "two-name paper."

## Sample Trade Transaction



## Participants in a Commercial Letter of Credit Transaction

The key roles that a bank may play in a commercial letter of credit transaction are described below. A bank may play more than one role in the transaction.

- Issuing or opening bank:** The bank that issues a documentary credit on the instructions of the importer (account party). The bank is usually, but not necessarily, the importer's own bank. It is obligated to pay if the documents presented are in accordance with the terms of the letters of credit. The issuing bank is usually located in the importer's country.
- Advising or notifying bank:** The bank that notifies the exporter (beneficiary) that a letter of credit has been opened by the issuing bank and informs the exporter of the terms and conditions of the letter of credit. The advising bank is usually located in the same place as the exporter and can be a branch office of the issuing bank or a correspondent bank. The issuing bank most often sends the letter of credit through its branch office or

correspondent bank to avoid fraud. The exporter, however, can request the importer to specify the exporter's bank as the advising bank. The exporter's bank might not be the issuing bank's correspondent bank. The advising bank is not responsible for the payment of the letter of credit that it advises unless it adds its own confirmation to pay.

- **Confirming bank:** The bank that has added its commitment to that of the issuing bank to pay the letter of credit, providing all the documents are in order. This commitment holds even if the issuing bank or the importer fails to make payment. Some beneficiaries (exporters), particularly those not familiar with the issuing bank, ask the buyer to have the letter of credit issued in the importer's country and "confirmed" by a bank in the exporter's country.
- **Negotiating bank:** The bank that negotiates or accepts the documents for examination and, if these documents are in order, remits payments to the beneficiary. The term "negotiation" arises when a letter of credit calls for sight draft but reimbursement is on a remittance basis or it takes time to be paid by a reimbursement bank. The negotiating bank normally is authorized by the issuing bank to negotiate documents and is specifically named in the letter of credit. If the letter of credit indicates that it is "available with any bank by negotiation," the issuing bank authorizes the beneficiary to present documents to the bank of his or her choice for examination and collection of payment. The negotiating bank is usually the paying bank.
- **Paying bank:** The bank that effects payment of documents negotiated under a letter of credit. It is usually also the negotiating bank, unless the letter of credit allows another bank to negotiate or the paying bank is unable to negotiate.
- **Reimbursing bank:** The bank with which the issuing bank maintains an account. This bank is authorized by the issuing bank to charge that account to pay claims received from the negotiating or paying bank for documents that have been presented.

## Appendix D: Guarantees

Issuing guarantees and sureties is permissible for national banks in certain circumstances. For example, these activities are permissible when the bank has a substantial interest in the performance of a transaction or when the bank has a segregated deposit from its customer sufficient in amount to cover its total potential liability. A national bank may guarantee the deposits and liabilities of its Edge Act and Agreement corporations and of its corporate instrumentalities in foreign countries under these provisions and 12 CFR 28.4(c).

Additionally, a national bank may guarantee obligations of a customer, subsidiary, or affiliate that are financial in character, provided the amount of the bank's financial obligation is reasonably ascertainable and otherwise consistent with applicable law. (Updated October 15, 2018)

Under certain circumstances, foreign branches of national banks may exercise powers exercised by banks in the host country pursuant to both the OCC's regulations for foreign operations of national banks at 12 CFR 28.4(a)(2) and the Federal Reserve Act at 12 USC 604a and 12 CFR 211 (Regulation K). Those powers include guaranteeing a customer's debts or agreeing to make payment upon certain readily ascertainable events. Such events include, but are not limited to, certain nonpayments (of taxes, rentals, customs duties, and transportation costs) and the loss or nonconformance of shipping documents. To comply with 12 USC 604a and its implementing regulation at 12 CFR 211.4(a)(1), the guarantee or agreement must specify a maximum monetary liability. 12 CFR 211.4(a)(1) also subjects liabilities outstanding to any one customer to the lending limits under 12 USC 84.

A common example of a guarantee subject to 12 USC 604a is a shipperside (steamer) bond.<sup>26</sup> Frequently, in an international sale of goods, the merchandise arrives at the importer's port before the arrival of correct and complete bills of lading. In such instances, it is customary for the importer to obtain immediate possession of the goods by providing the shipping company with a bank guarantee, often called a shipperside bond, that holds the shipping company blameless for damage resulting from release of the goods without proper or complete documents. Usually, the bank's guarantee relies on a counter-guarantee issued by the importer to the bank.

FSAs should follow 12 CFR 160.60 with respect to sureties and guarantees, as well as the lending limit restrictions contained in 12 USC 84 and 12 USC 1464(u) and the lending limit regulations in 12 CFR 32.

National banks and FSAs with legal questions about guarantees and surety in connection with trade finance or other transactions should consult their legal counsel. (Updated October 15, 2018)

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<sup>26</sup> It is also known as a steamship guarantee.

## Appendix E: Relevant Legislation

### Bank Secrecy Act

Trade finance activities of banks are subject to AML laws and regulations of the BSA (31 USC 5311-5330) and must be part of the bank's BSA compliance program. That program must include a customer identification program with risk-based procedures that enable the bank to form a reasonable belief that it knows the true identity of its customers. Under the Beneficial Ownership Rule,<sup>27</sup> banks must establish and maintain written procedures that are reasonably designed to identify and verify beneficial owner(s) of legal entity customers and include such procedures in their AML compliance programs. Banks must also develop and implement appropriate risk-based procedures for conducting ongoing customer due diligence (CDD). CDD should include obtaining and analyzing sufficient customer information to understand the nature and purpose of customer relationships for the purpose of (1) developing a customer risk profile and conducting ongoing monitoring to identify and report suspicious transactions and (2) on a risk basis, maintain and update customer information. Banks should use sound customer due diligence procedures and monitor transactions, with special scrutiny on higher-risk goods (e.g., weapons and nuclear equipment trade), geographies (e.g., drug-producing countries and countries that support terrorism), and customers in potentially high-risk businesses (e.g., jewel, gem, and precious metal dealers; wholesalers and retailers of consumer electronics; and commodities intermediaries). The involvement of multiple parties on both sides of any international trade transaction can make the customer due diligence process more difficult. (Updated October 15, 2018)

Bank policies, procedures, and processes should manage the risks associated with the bank's trade activities. Implementation of effective customer due diligence, suspicious activity monitoring, and reporting systems are important internal controls. Banks should obtain sufficient customer due diligence information (including information mandated by customer identification programs, from beneficial ownership requirements, and from screening and filtering names against OFAC sanction lists) on prospective import/export customers before establishing the account or credit relationship. The bank should conduct a thorough review and fully understand all trade finance documentation and related values. In addition, the sophistication of the reporting of unusual or suspicious activity and the MIS should be commensurate with the size and complexity of the bank's trade finance activities. (Updated October 15, 2018)

Because a commercial letter of credit requires a great number of documents, even relative to most other areas of banking, it is more susceptible to documentary fraud, which often accompanies money laundering, terrorist financing, or the circumvention of OFAC sanctions or other prohibitions. This situation generally occurs because banks rely on information stated in the documents and therefore pay the money against the documents rather than money against the goods. Documents may be falsified by over- or under-valuing the goods in an effort to launder money or evade customs regulations. For example, an importer may pay

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<sup>27</sup> Refer to 31 CFR 1010.230.

a large sum of money from the proceeds of an illegal activity for goods that are essentially worthless and are subsequently discarded. Trade documents, such as invoices, can be fraudulently altered to hide the scheme. The illegal proceeds transferred in the trade transaction appear sanitized and enter the realm of legitimate commerce.

## **Anti-Boycott Regulations of the Former Export Administration Act of 1979**

The anti-boycott provisions of the Export Administration Act of 1979 have been reclassified such that the new legal cite is 50 USC 4601 et seq. These anti-boycott provisions discourage and, in certain instances, prohibit U.S. persons or entities—including banks—from engaging in transactions related to boycotts imposed by foreign countries that are not sanctioned by the United States. The U.S. Department of Commerce’s Office of Antiboycott Compliance is responsible for implementing and enforcing the anti-boycott provisions of the act.<sup>28</sup> Many states also have implemented anti-boycott legislation. (Updated October 15, 2018)

The act expired on August 20, 1994, and was reauthorized by Pub. L. 106-508 (November 13, 2000). During the lapse, a national emergency declared under Executive Order 12924 (August 19, 1994) and extended by annual presidential notices ensured the continued validity of the regulations issued pursuant to the act. The act lapsed again on August 20, 2001, but the anti-boycott regulations have continued in force through various Executive Orders issued pursuant to the International Emergency Economic Powers Act and extended by successive presidential notices. See 83 Fed. Reg. 39.871 (August 13, 2018) for the latest extension. (Updated October 15, 2018)

The anti-boycott provisions apply to commercial letter of credit transactions that facilitate U.S. commerce when the beneficiary is a U.S. person. U.S. banks and their foreign branches, subsidiaries, and affiliates may not implement letters of credit containing prohibited boycott-related terms or conditions. Neither may branches, subsidiaries, or affiliates of foreign banks doing business in the United States. Implementing a letter of credit includes

- issuing or opening a letter of credit at the request of a customer.
- honoring, by accepting as being a valid instrument of credit, any letter of credit.
- paying, under a letter of credit, a draft or other demand for payment by the beneficiary.
- confirming a letter of credit by agreeing to be responsible for payment to the beneficiary in response to a request by the issuer.
- negotiating a letter of credit by voluntarily purchasing a draft from a beneficiary and presenting such draft for reimbursement to the issuer or the confirmer of the letter of credit.
- taking any other action to implement a letter of credit.

The act does not prohibit informing a beneficiary of the existence of a letter of credit or performing basic ministerial activities required to dispose of a letter of credit that contains prohibited boycott terms or conditions.

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<sup>28</sup> Regulations implementing the Export Administration Act of 1979 are at 15 CFR 730–774.

Common illegal boycott-related terms or conditions include

- a requirement from a boycotting country for certification that the goods did not originate from a boycotted country. (A positive certificate of origin, however, is legal.)
- a requirement from the boycotting country for certification that the exporter and importer do not do business with a boycotted country.
- a requirement for certification that the supplier of the goods or a provider of services does not appear on the blacklist of a boycotting country.
- the words “Do not negotiate with blacklisted banks,” or a condition to that effect.

Banks must report to the Commerce Department any letters of credit they receive that include prohibited boycott terms or conditions. See 15 CFR 760.5. Oral requests to take action that would advance or support an unsanctioned foreign boycott must also be reported. Failure to comply with the act can result in criminal or civil penalties, depending on the nature of the violation.

Examiners should review the adequacy of a bank’s system for monitoring compliance with the act. Possible violations of the anti-boycott regulations should be discussed with legal counsel and detailed in the ROE as appropriate.

## **OFAC Compliance**

(Section updated October 15, 2018)

Banks engaged in letters of credit or other trade financing need to remain aware of the need to comply with statutes such as the Trading With the Enemy Act of 1917 (50 USC appendix 1-44) and the International Emergency Economic Powers Act (50 USC 1701-1706), along with regulations of OFAC (see generally 31 CFR 501). Banks must comply with federal law and OFAC regulations. These laws and regulations prohibit transactions with individuals and entities located in certain countries, subject to certain exceptions. OFAC administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction. Banks should establish and maintain effective, written OFAC compliance programs that provide appropriate internal controls for screening and reporting, that establish independent testing for OFAC compliance, for reporting blocked and rejected transactions, and for maintaining OFAC license information when applicable.

Banks should not enter into transactions with prohibited individuals, banks, or entities, and should consult with OFAC as necessary. OFAC requires that all “U.S. persons” comply with OFAC regulations. In this context, “U.S. person” includes foreign branches and, often, foreign subsidiaries of U.S. banks; U.S. bank holding companies and nonbank subsidiaries; all U.S. citizens and permanent resident aliens regardless of where they are located; all persons and entities within the United States; and all U.S.-incorporated entities and their foreign offices. In the cases of certain programs, such as those regarding Iran and North Korea, all foreign subsidiaries owned or controlled by U.S. companies must comply. Certain

programs also require foreign persons in possession of U.S.-origin goods to comply. Failure to comply with OFAC sanctions and trading prohibitions can lead to criminal or civil penalties, depending on the nature of the violation.

Refer to the *FFIEC BSA/AML Examination Manual* for more information.

## **Export Trading Company Act of 1982**

The Export Trading Company Act (ETCA)<sup>29</sup> (12 USC 1843(c)(14), 15 USC 4001 et seq), enacted in October 1982, encourages exports by facilitating the formation and operation of export trading companies (ETC). This legislation encourages businesses to join together to offer export services by permitting certain banking institutions to own an interest in these exporting ventures and providing protection from antitrust laws. (Updated October 15, 2018)

An ETC's principal business is to export American goods and services or help unrelated U.S. companies export their products overseas. ETCs also can periodically engage in importing and trade between third countries in order to promote U.S. exports. Foreign ownership of ETCs is permissible.

The general provisions of the ETCA allow companies to pool resources through ETCs to market exports. The statute also authorizes the Commerce Department to issue a certificate of review, which grants ETCs qualified immunity from criminal or civil actions under the antitrust laws.

The ETCA does not give banks (other than banker's banks) authority to invest in ETCs. Congress attempted to reduce the risk posed by this breach in the traditional wall separating banking and commerce by allowing these investments to be made only through bank holding companies (BHC), Edge Act or Agreement corporations that are subsidiaries of BHCs, and banker's banks. The Federal Reserve Board, which has adopted regulations implementing the banking provisions of the ETCA, supervises the ETCs.

The banking provisions allow banker's banks and BHCs to own 100 percent of the stock of an ETC. Banker's banks and BHCs also can invest up to 5 percent and lend up to 10 percent of their capital and surplus to ETCs. The Federal Reserve Board must be given 60 days prior notification of a BHC's intent to invest in an ETC, and may disapprove the investment during the 60-day period.

Credit transactions between a national bank or FSA and an affiliated ETC are subject to the restrictions of sections 23A and 23B of the Federal Reserve Act (12 USC 371c and 12 USC 371c-1). Loans or extensions of credit from a national bank or FSA to an affiliated ETC in which a BHC has invested are subject to the collateral requirements of 12 USC 371c. Section 23A of the Federal Reserve Act and the Federal Reserve Board's Regulation W provide that the collateral requirements are not applicable to an acceptance that is already fully secured either by attached documents or by other property having an ascertainable value

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<sup>29</sup> This legislation does not apply to FSAs.



that is involved in the transaction.<sup>30</sup> 12 CFR 211.33(b)(3) provides an exception to the collateral requirements when a national bank issues a letter of credit or advances funds to an affiliated ETC solely to finance the purchase of goods for which the ETC has a buyer under a bona fide contract, and the bank has a security interest in the goods or in the proceeds from their sale at least equal in value to the letter of credit or advance.

In addition, pursuant to 12 USC 371c(f)(2)(B), the Comptroller of the Currency may, by order, waive the collateral requirement if (1) the Federal Reserve Board and the Comptroller jointly find the exemption to be in the public interest and consistent with the purposes of section 23A of the Federal Reserve Act; (2) the Federal Reserve Board and the Comptroller notify the Federal Deposit Insurance Corporation of such finding; and (3) the Federal Deposit Insurance Corporation does not object within 60 days of being notified of the exemption.

An ETC is prohibited from conducting certain activities, such as engaging in agricultural production or manufacturing except to repackage, reassemble, or extract by-products to meet foreign requirements. An ETC owned by a BHC may not take positions in commodities, commodity contracts, securities, or foreign exchange except as is necessary to support its trade finance activity.

## Other Legal Issues

Examiners should be aware of the laws that limit the amounts of certain kinds of letters of credit. Standby letters of credit and guarantees, which are defined as contractual commitments to advance funds, are subject to the limits of 12 USC 84 and, for FSAs, both 12 USC 84 and 12 USC 1464(u), and must be combined with any other nonaccepted loans to the account party by the issuing bank. (Updated October 15, 2018)

Because commercial letters of credit are repaid in nearly simultaneous operations by exporter and importer and do not result in the bank granting a loan to the account party, they are not defined as contractual commitments to advance funds under regulations governing lending limits (12 CFR 32.2(g)(2)).

Commercial letters of credit issued on behalf of an affiliate are subject to 12 USC 371c, 12 USC 371c-1, 12 CFR 223 (Regulation W) and, for FSAs, 12 USC 371c, 12 USC 371c-1, 12 CFR 223 (Regulation W), and 12 USC 1468, when the commercial letters of credit are drawn upon and the bank is not reimbursed on or before the date of payment of the letter of credit.

For FSAs, the Home Owners' Loan Act authorizes FSAs to purchase banker's acceptances (12 USC 1464(c)(1)(M) and 12 CFR 160.30). Examiners must consider compliance with the legal lending limit when reviewing banker's acceptances. Eligible banker's acceptances are subject to the lending limits of 12 USC 84 and 12 USC 1464(u) when the bank discounts or holds its own banker's acceptances, which are converted to a loan. For both national banks and FSAs, certain banker's acceptances described in 12 CFR 32.3(c)(2) are exempt from the lending limits of 12 USC 84 and 12 USC 1464(u).

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<sup>30</sup> 12 USC 371c(c)(4) and 12 CFR 223.14(f)(1).

## Appendix F: U.S. Government and Multilateral Agencies That Guarantee or Insure Export Financing

### U.S. Government Agencies

- **Export-Import Bank of the United States:** The Ex-Im Bank is the most widely known of the U.S. government agencies that guarantee or insure export financing. The Ex-Im Bank was founded in 1934 to finance and facilitate exports from the United States to other countries. The agency encourages commercial financing of U.S. exports through guarantees, export credit insurance, and direct loans to foreign buyers of U.S. exports. The Ex-Im Bank offers a number of products as well as differing eligibility, coverage, and term requirements. Information about Ex-Im Bank products is available at [www.exim.gov](http://www.exim.gov).
- **Overseas Private Investment Corporation:** The Overseas Private Investment Corporation began operations in 1971. The agency's mission is to promote economic growth in developing countries by encouraging U.S. private investment in those nations. It provides political risk insurance; finances medium- to long-term investment through direct loans and loan guarantees; and supports creation of investment funds for equity investment. Information about the agency's programs is available at [www.opic.gov](http://www.opic.gov).
- **U.S. Small Business Administration:** The U.S. Small Business Administration provides repayment guarantees to lenders that finance small businesses under its export financing programs. The programs include short-term working capital loans and long-term international trade loans. Information about the agency's export financing programs is available at [www.sba.gov](http://www.sba.gov).
- **Commodity Credit Corporation:** The Commodity Credit Corporation was reincorporated in 1948 as a federal corporation within the U.S. Department of Agriculture. The corporation has established export programs that provide guarantees to U.S. lenders that meet program requirements. See [www.fsa.usda.gov](http://www.fsa.usda.gov) for information about the corporation and its export programs.

### Multilateral Agencies

- **International Finance Corporation:** A member of the World Bank Group, the International Finance Corporation provides direct trade financing and guarantees trade payment obligations as part of its investment and advisory services for developing countries around the world. Information about the corporation is available at [www.ifc.org](http://www.ifc.org).
- Other multilateral development banks such as the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, and the European Investment Bank provide guarantees to banks to support trade in their regions.

## Appendix G: Accounting Practices

### Letters of Credit

Financial guarantee contracts are generally addressed under Accounting Standards Codification Topic 460, “Guarantees” (ASC 460). This guidance establishes the accounting and disclosure requirements by a guarantor for certain guarantees issued and outstanding. For certain guarantees, the guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. Among the types of guarantee contracts to which the provisions of ASC 460 apply are

- financial standby letters of credit, which are irrevocable undertakings, typically by a financial institution, to guarantee payment of a specified financial obligation.
- performance standby letters of credit, which are irrevocable undertakings by a guarantor to make payments in the event a specified third party fails to perform under a nonfinancial contractual obligation.

Commercial letters of credit and other loan commitments, which are commonly thought of as guarantees of funding, are not included in the scope of ASC 460 and instead are accounted for under ASC 450, “Contingencies.” Banks should refer to ASC 460 for further information on the types of guarantee contracts to which the interpretation’s initial recognition and measurement provisions do and do not apply.

For financial and performance standby letters of credit and other types of guarantees within the scope of ASC 460 and subject to its recognition requirements under ASC 460-10-25, when a bank issues the guarantee, it must recognize on its balance sheet a liability for that guarantee. In general, the initial measurement of the liability is the fair value of the guarantee at its inception. When a bank issues a guarantee in a stand-alone arm’s-length transaction with a party outside the consolidated bank, which would typically be the case for a standby letter of credit, the liability recognized at the inception of the guarantee should be the premium or fee received or receivable by the guarantor. If the bank issues a guarantee for no consideration on a stand-alone basis, however, the liability recognized at inception should be an estimate of the guarantee’s fair value. In the unusual circumstance when, at the inception of a guarantee, it is probable that a loss has been incurred and its amount can be reasonably estimated, the liability initially recognized for that guarantee should be the greater of the premium or fee received or receivable by the guarantor or the estimated loss from the loss contingency that must be accrued under ASC 450.

ASC 460 does not prescribe a specific account for the guarantor’s offsetting entry when it recognizes the liability at the inception of a guarantee, because that offsetting entry depends on the circumstances. If a bank issued a standby letter of credit or other guarantee in a stand-alone transaction for a premium or fee, the offsetting entry would reflect the consideration the bank received, such as cash, a receivable, or a reduction of a deposit liability. In contrast, if the bank received no consideration for issuing the guarantee, the offsetting entry would be to expense.

The accounting for fees received for issuing standby letters of credit is governed by ASC 310, "Receivables."

For reporting purposes, standby letters of credit (like undisbursed commercial letters of credit) are shown as contingent liabilities on the issuer's balance sheet. Once a standby letter of credit is drawn upon, the amount drawn becomes a direct liability of the issuing bank.

## Acceptances

A banker's acceptance must appear on the bank's financial statement as a liability and an asset. The outstanding acceptance is listed as a liability (acceptances executed) and the customer's liability to pay the bank at the acceptances' maturity is shown as an asset (customers' liability for acceptances).

If a banker's acceptance is the result of a letter of credit, the contingent liability for the letter of credit may be reduced when the banker's acceptance is finalized.

When a bank creates a banker's acceptance, it receives a fee without advancing its own funds until the acceptance matures. The accounting for fees received by the bank is governed by ASC 310-20. The drawer may hold the banker's acceptance until maturity, discount it with his or her own bank, or sell it in the acceptance market. If the bank discounts (purchases) its own acceptance, its customers' liability for acceptances (asset) accounts and its acceptances-executed (liability) accounts are reduced and the discounted acceptance is recorded with loans and discounts. In this instance, the bank advances its own funds to the customer. If the bank subsequently rediscounts the banker's acceptance in the market, that acceptance should be rebooked as a customer liability for acceptances and acceptances executed. A bank's own acceptances, if discounted (purchased), are reflected as loans, but, as a practical matter and for accounting convenience, they are not generally deducted from customer liability for acceptances and acceptances-executed accounts (except for published call report and ROE purposes).

The customer's liability for acceptances accounts and acceptances-executed accounts may differ only when the asset account is reduced by the customer's prepayment (anticipation) of the acceptance. In that instance, the customer's liability to the bank is reduced by the amount of the payment, but the bank's liability for acceptance (acceptances executed), which is still outstanding in the market, is not reduced. The customer may prepay the bank either the full amount of the liability or any part of it. Customers' funds held to meet acceptances must be considered as deposits and should be reflected as such by the bank if they are not immediately applied to reduce indebtedness.

Most banker's acceptances purchased as investments are created by other banks. A bank should report these acceptances at cost under acceptances of other banks on its financial statement and on the call report in Schedule RC-C. The discount should be accreted over the expected remaining life of the acceptance. Banker's acceptances purchased for trading purposes should be reported at fair value in the trading account.

## Appendix H: Sample Request Letter

**Note:** This appendix is provided as a guide and should be modified as needed depending on the scope of the supervisory activity and the risk profile of the bank. The EIC should indicate which items need to be provided before the start of the supervisory activity and which will be reviewed during the on-site portion of the supervisory activity. If activities are being conducted throughout the supervisory cycle, examiners should only request the information they need to complete the current activity. The EIC is responsible for getting the general information and maintaining it in supervisory information systems to avoid duplicate requests to the bank.

Examiners should tailor the following request list as needed, based on the bank's activities.

In order for us to prepare effectively for this supervisory activity, please provide the information listed in the attachment to this request letter in electronic format and send it to the designated EIC via OCC secure mail or large file transfer tool, which can be accessed by going to [www.banknet.gov](http://www.banknet.gov). If this is not possible, we request the data be faxed to a designated number at our office. For larger pieces of hard-copy information and for security purposes, we request that you provide the information by mail using a "tracking" service. Please indicate whether hard-copy information needs to be returned. (Updated October 15, 2018)

### Management and Supervision

1. Current organizational charts, including names of key trade management and personnel.
2. Résumés detailing experience of key trade management and personnel.
3. Formal job descriptions for all key trade positions.
4. The bank's current trade strategy and business plan.
5. Descriptions of trade products and programs offered.
6. Key monthly, quarterly, and annual management reports.
7. Reports to the board or relevant board committee.
8. Recent internal audit and, if applicable, risk assessment reports.
9. Policies and procedures governing trade business, operations, and compliance. If available, include process flowcharts.

### Business and Operational Performance

10. Trade finance and services volume and growth trend, by product type.

11. Profit and loss statement and budget, if applicable.
12. A list of pending litigation affecting trade finance and services.
13. A list of top trade clients.
14. Trade credit delinquency trend.
15. Trade finance clients that are classified and special mention.
16. Volume and nature of credit exceptions.
17. Country exposure growth trend.
18. Most recent credit risk review report.
19. Volume and nature of document discrepancies, operational errors, control deficiencies, customer complaints or disputes, policy exceptions, etc., and their resolutions.
20. Losses and recoveries by product, including a brief description, date, and amount.
21. If applicable, a list of insourcing and outsourcing arrangements with a description of services and names of clients or third-party vendors.
22. Listing of technology platforms and vendor software programs that the bank uses for processing trade transactions or managing compliance risk.  
  
(As appropriate, consult the applicable *FFIEC IT Examination Handbook* booklet for additional information to be requested.)
23. The roles and responsibilities for reviewing compliance with laws and regulations, contractual obligations, and bank policies as they pertain to trade finance and services. Please make available relevant compliance review reports.  
  
(As appropriate, consult the *FFIEC BSA/AML Examination Manual* for additional information to be requested.)
24. Volume and growth trend of banker's and trade acceptances.
25. Volume and growth trend of acceptances of nonprime banks and ineligible banker's acceptances.
26. A list of trade credits sold, either outright or through participation. Please indicate whether with or without recourse.

27. If applicable, a list of export credit programs.
28. Distribution of the tenor of the trade portfolio.
29. Volume and growth trend of the trade portfolio with fixed vs. floating interest rate.
30. If applicable, volume of trade portfolio denominated in foreign currencies.

## Appendix I: Glossary

**Amendment:** Alteration to the terms of a commercial letter of credit. Amendments must stem from the applicant (buyer) and be issued and advised to the beneficiary. The beneficiary has the right to refuse an amendment if the credit is irrevocable.

**At sight:** A term indicating that a negotiable instrument is payable upon presentation or demand.

**Avalize:** The act by a bank of guaranteeing payment of a bill of exchange or promissory note by endorsing the front or reverse with the words “good per aval” and signing it, or by the issuance of a separate guarantee. The avalized bank becomes obligated to pay the draft at maturity if the drawee/acceptor fails to do so.

**Banker’s acceptance—clean:** A banker’s acceptance that does not involve a documentary letter of credit.

**Bill of exchange:** An instrument by which the drawer (the issuer or signer of a draft) orders another party (the drawee) to pay a certain sum to a third party (the payee) at a definite future time. The terms “bill of exchange” and “draft” are generally interchangeable.

**Bill of lading—clean:** A bill of lading in which the described merchandise has been received in “apparent good order and condition” and without qualification.

**Bill of lading—order:** A bill of lading, usually drawn to the order of the shipper, that can be negotiated like any other negotiable instrument.

**Bill of lading—straight:** A bill of lading drawn directly to the consignee and therefore not negotiable.

**Bill of lading—through:** A bill of lading used when several carriers are used to transport merchandise, for example, from a train to a vessel or vice versa.

**Bill of lading—unclean:** A bill of lading across the face of which exceptions to the receipt of goods “in apparent good order” are noted. Examples of exceptions include burst bales, rusted goods, and smashed cases.

**Certificate of inspection:** A document, often required for shipment of perishable goods, certifying the good condition of the merchandise immediately before shipment.

**Certificate of origin:** A document issued by the exporter certifying the place of origin of the merchandise to be exported. The information contained in this document is needed primarily to comply with tariff laws that may extend more favorable treatment to certain countries’ products.



**Collecting bank:** A bank that acts as an agent for a remitting bank that wishes to have its collections handled. The collecting bank demands payment from the importer and handles the funds received as instructed; generally, the funds are sent back to the remitting bank.

**Consular documents:** Bills of lading, certificates of origin, or special forms of invoice that carry the official signature of the consul of the country of destination.

**Consular invoice:** A detailed statement on the character of goods shipped that is duly certified by the consul at the port of shipment. Required by certain countries, including the United States, its principal function is to accurately record the types of goods and their quantity, grade, and value for import duty and general statistical purposes.

**Cost, insurance, and freight (CIF):** A price quotation under which the seller defrays all expenses involved in the delivery of goods.

**Draft:** See bill of exchange.

**Drawee:** The addressee of a draft, that is, the person on whom the draft is drawn.

**Drawer:** The issuer or signer of a draft.

**Edge Act:** This act authorized the Board of Governors of the Federal Reserve System to charter corporations (Edge corporations) for the purpose of engaging in international or foreign banking or in other international operations.

**Free alongside ship (FAS):** A term for a price quotation under which the seller delivers merchandise free of charge to the steamer's side and pays transfer and transportation expenses up to that destination, if necessary.

**Free on board (FOB) (destination):** A term for a price quotation under which the seller undertakes at his or her risk and expense to load the goods on a carrier at a specified location. Expenses subsequent thereto are for account of the buyer.

**Free on board (FOB) (vessel):** A term for a price quotation under which the seller delivers the goods at his or her expense on board the steamer at the location named. Subsequent risks and expenses are for account of the buyer.

**Incoterm:** An International Chamber of Commerce official rule for the interpretation of trade terms.

**Independent undertakings:** An obligation under applicable law or rules of practice recognized by law that depends upon the presentation of specified documents and not upon nondocumentary conditions or resolution of factual or legal questions. (Updated October 15, 2018)

**Letter of credit—back-to-back:** A letter of credit issued on the strength (or backing) of another letter of credit, involving a related transaction and nearly identical terms. For example, ABC company in the United States is designated as the beneficiary of an irrevocable letter of credit confirmed by a U.S. bank to supply XYZ company in Bolivia, whose bank issued the letter of credit, with goods to be purchased from a third company. The third company, however, will not fill ABC's order unless it receives prepayment for the goods, through either cash or some other type of financing. If ABC is unable to prepay in cash, it will request its bank to issue a letter of credit in favor of the third company based on the terms of the original letter issued by XYZ's bank. If ABC's bank agrees, the domestic credit is then "backed" by the foreign letter of credit, and a back-to-back letter of credit transaction exists.

Back-to-back letters of credit are appropriate when the exporter, acting as an agent or intermediary, does not have the funds to pay the manufacturer and does not want the manufacturer to know the name of the importer (because the manufacturer may try to deal directly with the importer). The letter of credit issued to the manufacturer does not carry the name of the importer. Timing is critical for back-to-back letters of credit because the back-to-back arrangement increases the possibility that goods will be shipped after the letter of credit's expiration date. Generally, a bank issuing a back-to-back letter of credit is the paying bank on the original letter of credit and is willing to accept the credit risk of both the exporter and the original issuing bank, as well as the transfer risk of the importing country.

**Letter of credit—deferred payment:** A letter of credit under which the seller's draft specifies that the draft is payable at a later date, for example, 90 days after the bill-of-lading date or 90 days after presentation of the documents. Deferred payment letters of credit, which become direct liabilities of a bank after presentation and receipt of the beneficiary's documents, involve greater potential risk because of the length of time the credit is outstanding.

**Letter of credit—green clause:** Similar to the red clause letter of credit below, except that advance payment is made, generally upon presentation of warehouse receipts evidencing storage of the goods.

**Letter of credit—red clause:** In a red clause letter of credit (a clause on the instrument is printed in red ink), the issuing bank authorizes a negotiating bank to advance funds to an exporter before the shipment of goods and presentation of documents. Once shipment is made and documents are presented in good order under the credit, the advance is repaid from the proceeds due to the beneficiary under the letter of credit. The strength of the relationship between buyer and seller is a key consideration in this structure. A red clause credit is also called a packing credit.

**Letter of credit—revolving:** A letter of credit issued for a specific amount that renews itself for the same amount over a given period. Usually, the unused renewable portion of the credit is cumulative so long as drafts are drawn before the expiration of the credit.

**Letter of credit—straight:** A credit requiring presentation on or before the expiration date at the office of the paying bank. The engagement clause to honor drafts is in favor of the beneficiary only.

**Letter of credit—transferable:** A credit under which the beneficiary has the right to give instructions to the bank called upon to effect payment or acceptance to make the credit available in whole or in part to one or more third parties (second beneficiaries). The credit may be transferred only upon the express authority of the issuing bank and provided that it is expressly designated as transferable. It may be transferred in whole or in part but may only be transferred once.

**Letter of credit—traveler's:** A letter of credit addressed to the issuing bank's correspondents, authorizing them to negotiate drafts drawn by the beneficiary named in the credit upon proper identification. The customer is furnished with a list of the bank's correspondents. Payments are endorsed on the reverse side of the letter of credit by the correspondent banks when they negotiate the drafts. This type of letter of credit is usually prepared by the customer.

**Letter of credit—usance:** A letter of credit that calls for payment against time drafts, drafts calling for payment at some specified date in the future. Usance letters of credit allow buyers a grace period of a specified number of days, usually not longer than six months.

**Presenting bank:** The bank that requests payment of a collection bill. It may be the collecting bank or its nominated branch or local correspondent, which is better placed to contact the importer.

**Remitting bank:** In a collection transaction, the exporter's bank that remits the bill to the collecting bank.

**Sight draft:** A draft payable upon presentation to the drawee or within a brief period thereafter known as days of grace.

**Tenor:** A term designating payment of a draft as being due at sight, a given number of days after sight, or a given number of days after the date of the draft.

**Time draft:** A draft drawn to mature at a fixed time after presentation or acceptance.

**Trust receipt:** Used extensively in letter of credit financing, this is a document or receipt in which the buyer promises to hold the property received in the name of the releasing bank, although the bank retains title to the goods. The merchant is called the trustee, and the bank is the entruster. Trust receipts are used primarily to allow an importer to take possession of the goods for resale before payment to the issuing bank.

**Usance:** The period between presentation of a draft and its maturity.

**Warehouse receipt:** An instrument that lists and is a receipt for goods or commodities deposited in the warehouse that issues the receipt. These receipts may be negotiable or nonnegotiable. A negotiable warehouse receipt is made to the bearer, while a nonnegotiable warehouse receipt specifies precisely to whom the goods shall be delivered. There are several alternatives for releasing goods held under warehouse receipts: (1) the delivery of goods may be allowed only against cash payment or substitution of similar collateral, (2) some or all of the goods may be released against the trust receipt without payment, or (3) a warehouse manager may release a stipulated quantity of goods without a specific delivery order. Banks accept a warehouse receipt as collateral for a loan only if the issuer of a receipt is a bonded warehouse manager. The bank must have protected assurances for the authenticity of the receipt and the fact that the commodities pledged are fully available as listed on the warehouse receipt.

**White labeling:** A white-label product or service is a product or service produced by one company (e.g., the insourcing bank) that other companies (e.g., the outsourcing bank) rebrand to make it appear as if they made it.

## Appendix J: Abbreviations

(Section updated October 15, 2018)

AML	anti-money laundering
ASC	Accounting Standards Codification
BHC	bank holding company
BSA	Bank Secrecy Act
CDD	customer due diligence
D/A	documents against acceptance
D/P	documents against payment
EIC	examiner-in-charge
ETC	export trading company
ETCA	Export Trading Company Act
FFIEC	Federal Financial Institutions Examination Council
ICC	International Chamber of Commerce
ICERC	Interagency Country Exposure Review Committee
ICQ	internal control questionnaire
ISP98	International Standby Practices, 1998 edition
MIS	management information systems
OCC	Office of the Comptroller of the Currency
OFAC	Office of Foreign Assets Control
PEFCO	Private Export Funding Corporation
ROE	report of examination
SWIFT	Society for Worldwide Interbank Financial Telecommunications

UCC      Uniform Commercial Code

UCP      Uniform Customs and Practices for Documentary Credits

## References

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(Section updated October 15, 2018)

### Laws

- 12 USC 84, “Lending Limits”
- 12 USC 346, “Discount of Acceptances”
- 12 USC 371c, “Banking Affiliates”
- 12 USC 371c-1, “Restrictions on Transactions With Affiliates”
- 12 USC 372, “Bankers’ Acceptances” (national banks)
- 12 USC 373, “Acceptance of Drafts for Furnishing Dollar Foreign Exchange” (national banks)
- 12 USC 375a, “Loans to Executive Officers of Bank”
- 12 USC 375b, “Extensions of Credit to Executive Officers, Directors, and Principal Shareholders of Member Banks”
- 12 USC 604a, “Regulations Authorizing Exercise by Foreign Branches of Usual Powers of Local Banks; Restrictions” (national banks)
- 12 USC 1464, “Federal Savings Associations” (FSAs)
- 12 USC 1467a, “Regulation of Holding Companies” (FSAs)
- 12 USC 1468, “Transactions With Affiliates, Extensions of Credit to Executive Officers, Directors, and Principal Shareholders” (FSAs)
- 12 USC 1843, “Interests in Nonbanking Organizations” (national banks)
- 15 USC 4001 et seq, “Export Trading Company Act” (national banks)
- 31 USC 5311-5330, “Bank Secrecy Act”
- 50 USC 1701-1706, “International Emergency Economic Powers Act”
- 50 USC 4301-4341, “Trading With the Enemy Act”
- 50 USC 4601 et seq, “Export Administration Act of 1979” (repealed), anti-boycott provisions of, and regulations thereto, in force pursuant to Presidential Order under the International Emergency Economic Powers Act

### Regulations

#### National Banks and FSAs

- 12 CFR 21.21, “Procedures for Monitoring Bank Secrecy Act (BSA) Compliance”
- 12 CFR 32, “Lending Limits”
- 12 CFR 204, “Reserve Requirements of Depository Institutions”
- 12 CFR 215, “Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks (Regulation O)”
- 12 CFR 223, “Transactions Between Member Banks and Their Affiliates (Regulation W)”
- 15 CFR 760, “Restrictive Trade Practices or Boycotts”
- 31 CFR 501, “Reporting, Procedures, and Penalties Regulations”

**National Banks**

- 12 CFR 7.1007, “National Bank Acceptances”
- 12 CFR 7.1016, “Independent Undertakings Issued by a National Bank to Pay Against Documents”
- 12 CFR 7.1017, “National Bank as Guarantor or Surety on Indemnity Bond”
- 12 CFR 7.1020, “Purchase of Open Accounts by a National Bank”
- 12 CFR 21.11, “Suspicious Activity Report”
- 12 CFR 28.4, “Permissible Activities”
- 12 CFR 211, “International Banking Operations (Regulation K)”
- 12 CFR 250.165, “Bankers’ Acceptances: Definition of Participations”

**FSAs**

- 12 CFR 160.30, “General Lending and Investment Powers of Federal Savings Associations”
- 12 CFR 160.50, “Letters of Credit and Other Independent Undertakings—Authority”
- 12 CFR 160.60, “Suretyship and Guaranty”
- 12 CFR 160.120, “Letters of Credit and Other Independent Undertakings to Pay Against Documents”
- 12 CFR 163.180, “Suspicious Activity Reports and Other Reports and Statements”

**Comptroller’s Handbook****Examination Process**

- “Bank Supervision Process”
- “Community Bank Supervision”
- “Federal Branches and Agencies Supervision”
- “Foreword”
- “Large Bank Supervision”
- “Sampling Methodologies”

**Safety and Soundness, Asset Quality**

- “Accounts Receivable and Inventory Financing”
- “Asset-Based Lending”
- “Commercial Loans”
- “Concentrations of Credit”
- “Country Risk Management”
- “Loan Portfolio Management”
- “Rating Credit Risk”

**Safety and Soundness, Liquidity**

- “Asset Securitization”



**Safety and Soundness, Management**

“Corporate and Risk Governance”

“Internal and External Audits”

**Safety and Soundness, Sensitivity to Market Risk**

“Foreign Exchange”

**Safety and Soundness, Other Activities**

“Payment Systems and Funds Transfer Activities”

**OCC Issuances**

Banking Circular 181 (Rev), “Purchases of Loans in Whole or in Part-Participations”  
OCC Bulletin 2009-8, “Country Risk: Changes to the Interagency Country Exposure Review Committee Process”

OCC Bulletin 2010-24, “Interagency Guidance on Sound Incentive Compensation Policies”

OCC Bulletin 2013-29, “Third-Party Relationships: Risk Management Guidance”

OCC Bulletin 2017-7, “Third-Party Relationships: Supplemental Examination Procedures”

OCC Bulletin 2017-21, “Third-Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29”

OCC Bulletin 2017-43, “New, Modified, or Expanded Bank Products or Services: Risk Management Principles”

**Other****Financial Accounting Standards Board**

ASC 310, “Receivables”

ASC 450, “Contingencies”

ASC 460, “Guarantees”

**Federal Financial Institutions Examination Council**

*FFIEC Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual*

*FFIEC Information Technology (IT) Examination Handbook*

“Business Continuity Planning”

“Development and Acquisition”

“Information Security”

“Outsourcing Technology Services”

“Supervision of Technology Service Providers”

“Wholesale Payment Systems”

**International Chamber of Commerce**

*International Standby Practices, 1998 edition*

*Uniform Customs and Practices for Documentary Credit*

**National Conference of Commissioners on Uniform State Laws**

*Uniform Commercial Code*

## Table of Updates Since Publication

Refer to the “Foreword” booklet of the *Comptroller’s Handbook* for more information regarding the OCC’s process for updating *Comptroller’s Handbook* booklets.

Version 1.0: Published April 15, 2015			
Version number	Date	Reason	Affected pages
1.1	October 15, 2018	Clarified applicability to federal branches and agencies of foreign banking organizations	1
		Clarifications regarding supervisory guidance, sound risk management practices, or legal language	3, 8–10, 16, 18–23, 25–26, 39, 41–47, 54, 56, 69, 77, 83–86
		Updated for clarity	5–6, 13–15, 20–27, 49, 73, 81
		Consistency with 12 CFR 7.1016–1017	6, 36, 38–39, 81
		Consistency with the OCC’s risk-based supervision approach	8
		Third-party risk management guidance and examination procedures (OCC Bulletins 2017-7 and 2017-21)	16, 18, 32, 42, 45, 47
		Consistency with the booklets in the “Examination Process” series of the <i>Comptroller’s Handbook</i>	17, 24, 28–29, 41, 48–49, 52, 54, 56–58, 60
		Reflect applicability of 12 USC 371c, 12 USC 371c-1, and 12 CFR 223 to FSAs	20, 35
		Corrected reference to “Foreign Exchange” booklet of the <i>Comptroller’s Handbook</i>	23, 40, 43, 45, 50, 61
		OCC Bulletin 2017-43, “Risk Management of New, Modified, or Expanded Bank Products and Services: Risk Management Principles” (removed references to rescinded OCC Bulletin 2004-20)	23, 25, 42
		Consistency with 12 USC 604a and 12 CFR 11	39
		Added examination procedures regarding compliance with statutes and regulations regarding transactions with affiliates and insiders.	39–40
		Reflect integration of FSAs into 12 CFR 31 (removed reference to former 12 CFR 163.43, which replaced by 12 CFR 31.2(a))	39
		Added reference to “Concentrations” booklet of the <i>Comptroller’s Handbook</i>	41
		Added reference to “Compliance Management Systems” booklet of the <i>Comptroller’s Handbook</i>	44
Reflect requirements of 31 CFR 1010.203, “Beneficial Ownership Requirements for Legal Entity Customers”	82		
Reflect reclassification of the anti-boycott provisions of the Export Administration Act of 1979 to 50 USC 4601	83		

	Reflect extension of International Emergency Powers Act	83
	Consistency with <i>BSA/AML Examination Manual</i>	84–85
	Added statutory citations for the Export Trading Company Act	85
	Added the OCC's Large File Transfer tool as a method to provide requested information to the OCC	90
	Added term to the "Glossary" section	94
	Updated "Abbreviations" section for consistency with the content of the booklet	98–99
	Updated "References" section for consistency with the content of the booklet	100–102