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Anti-Fraud in International Supply Chain Finance: Focusing on Moneual Case

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Abstract

Purpose – This study analyzes the scope of due diligence and risks of banks and K-Sure in trade finance covered by EFF focusing on Moneual case, one of the latest and biggest trade finance fraud cases in Korea. Also, we suggest anti-fraud measures in trade finance on the part of banks and K-Sure in order to give them a desirable way of due diligence and reasonable risk management of export insurance.

Design/methodology – Based on Moneual case of trade finance fraud, this study employs the methodology of an extended literature review and analysis of court decisions.

Findings – Seoul High Court of Korea failed to decide whether K-Sure was wholly obliged to pay the insurance against the banks' EFF claims, but issued a compulsory mediation order, judging that both the banks and K-Sure were responsible by 50:50. The court may have judged that both the parties had lacked their due diligence in the trade finance. It is quite difficult for trade finance providers to manually investigate whether the transaction is suspected of trade finance fraud, so digitalization of trade finance which can facilitate the prevention and detection of trade fraud needs to be realized quickly. Since there has been no international rule available for open account trade finance up till now, clearly stipulated EFF terms on the exporter's genuine export obligation might have protected K-Sure from the disaster.

Originality/value – This study investigates the due diligence of the banks and K-Sure in Moneual case which few researchers have considered, to the best of our knowledge. This study also suggests several practical methods (including block chain) to prevent complicating trade finance fraud amid increasing use of an open account, and further offers reasonable risk management of EFF employing international factoring rule which is also related to problematic open account trade finance.

Keywords: Due Diligence, Export Financing Facility (EFF), Open Account, Trade Finance Fraud, Moneual Case
JEL Classifications: F34, G21, N70

1. Introduction

Most of world trade is carried out under "Open Account" terms these days, whereby the buyer and seller agree to the terms of the contract and goods are delivered to the buyer followed by a payment through the bank (Wolfsberg Group, ICC and BAFT, 2019). Under open account, the goods, together with all the documents, are shipped directly to the importer who agreed to pay the exporter on a specified date. The exporter should be confident that the importer will accept the shipment and pay at the agreed time and that the importing country is commercially and politically secure. Supply chain finance refers to the

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set of solutions available for financing specific goods as they move from one country to another along the supply chain (Wikipedia, 2019 a). Banks may support open account trade transactions with supply chain finance techniques to allow buyers and sellers to optimize their working capital. Therefore, open account terms may help win customers in competitive markets and can be used with one or more of the appropriate trade finance techniques that mitigate the risk of non-payment (U.S. Department of Commerce International Trade Administration, 2008).

Under such open account terms, however, banks may not be willing to provide clean credit facilities, because of risks involved in financing trade receivables[1]: credit risk that the buyer does not or will not pay the sum due, performance risk that the buyer raises a dispute and so dilutes his obligation to pay, thus rightfully paying less than expected, and fraud risk that the receivable does not actually exist or is not as represented. Aside from these risks, banks may sometimes have to deal with documents presented to them, while on their face appearing to constitute a complying presentation, which are in effect forged, altered, and fraudulent. Yet, there are no international rules governing banks' document examination for open account financing, unlike documentary credit where UCP600 is employed as governing rules as to the standard for banks' document examination.

Besides, trade finance providers such as banks and export credit agencies (ECA)[2] have not been very successful in countering fraud with their traditional instruments. Only a small percentage of fraud cases have been detected, and the majority of fraud cases remain undiscovered. When trade finance fraud occurs, substantial amount of losses may be incurred. For example, Chinese regulatory authorities uncovered almost $10 billion in fraudulent trade-financing deals during the year 2014 alone (SAS, 2015).

To prevent or at least mitigate the risk of fraud, therefore, trade financiers need to thoroughly fulfill their due diligence, monitoring any activities suspected of fraud before it really happens. To this end, this paper, with the analysis of court cases in Korea, tries to suggest how trade financiers, particularly banks and ECA, can avoid falling a victim to trade finance fraud amid increasing use of OA payment as part of international supply chain finance.

With regard to the precedent studies on open account trade finance problems; Choi Byeong-Gyu (2012) analyzed short term export financing facility (EFF) in line with the introduction of K-IFRS. Oh Won-Suk and An Yu-Shin (2016) found that the EFF was based on international factoring. Park Seung-Lak (2018) suggested a bank procedure to prevent fraudulent transactions in terms of document examination. Yoo Ju-Seon and Kim Dong-Min (2018) pointed a way to prevent fraud in a trade insurance contract. Seo Jung-Doo (2019) claimed that the negotiating bank of exporter's receivables has the primary responsibility of checking trade documents as good manages, and so the bank that purchased the fraudulent exporter's receivables without careful and due diligence of examination is not entitled to receive the insurance amount from ECA.

Speaking of Moneual case of our interest, six banks in Korea were involved in trade financing for Moneual, a medium-sized manufacturing company based in Korea, which engaged in trade finance fraud by inflating prices and receiving trade finance at first, but later

[1] Trade generally involves the creation of trade receivables. These arise where the exporter ships, but the buyer pays later - a "ship now, pay later" trade. The obligation of the buyer to pay later is a receivable - a "trade receivable" - which is a fancy name for an outstanding invoice. Trade receivables are usually short-dated, with typical credit periods of 30, 60, 90, 120 days (Primadollar, 2019).

[2] ECA is an institution that offers to finance domestic companies' export operations. ECAs provide insurance and loans to companies to help eliminate the uncertainty of exporting to other countries.

got a discount on export receivables at the banks with fake shipping documents without conducting actual shipments. When the banks became unable to collect money from the importer and failed to retrieve about 314 billion won from Moneual in 2014, they claimed an export insurance against K-Sure. However, K-Sure refused to pay the insurance declaring that the banks are at fault for not detecting false exports. Seeking the insurance payment, the banks filed a lawsuit against K-Sure. Seoul High Court of Korea, at that time, rather than making a clear decision on the case, but issued an order of compulsory mediation that K-Sure pay the banks 50 percent of the claimed amounts.

This case has attracted attention of a number of researchers with special regard to whether K-Sure was obliged to pay the insurance such as Choi Byeong-Gyu (2016), Han Ki-Jung and Choi Jun-Gyu (2016), Jung Gyung-Young (2017) and Seo Jung-Doo (2019). However, few researchers have shed light on the due diligence of the concerned parties in the case.

To fill the gap, therefore, this study attempts to analyze the scope of due diligence and risks run by banks and K-Sure in trade finance covered by EFF, in the light of Moneual case, one of the biggest and latest trade finance fraud cases in Korea. Also, on the part of banks and K-Sure, we try to suggest some anti-fraud measures in trade finance. The methodology used in this work is an extended literature review, analysis of court decisions and international rules of account receivables.

2. Open Account and Supply Chain Finance

2.1. Supply Chain Finance Overview

Trade finance is provided mainly by commercial banks to support buyers/importers and sellers/exporters that are trading and collaborating along the supply chains in international trade (Grath, 2013). The expression "supply chain finance" (SCF) refers to a single product or a comprehensive range of products, programs solutions aimed at addressing the needs of buyers and sellers, especially in international trade on open account terms, in the increasingly complex supply chains that they are involved in (GSCFF, 2016). Malaket (2014) defined SCF as techniques of financing or credit support for the settlement of goods purchased and linking payment and finance to commercial and financial documents and also as techniques of risk mitigation against a default of payment, non-delivery of goods, country, political, and economic risks.

Trade finance is needed when exporters and importers need financing to fill the financial gap arising from the trade cycle. Traders can also choose to use trade finance as a form of risk mitigation through banks or ECA. In this case, the financiers often require: control for the use of funds, control for the goods and the source of repayment to obtain security over goods and receivables.

Traditional trade finance techniques are related to instruments such as documentary credits, documentary collections and demand guarantees, which are usually governed by rules published by the ICC publications such as UCP 600 for letters of credit, ISP 98 for standby LC, URC 522 for documentary collections, URDG 758 for demand guarantees (Global Supply Chain Finance Forum, 2016). Torquato (2016) calls them traditional as they are well regulated by long-established rules and can derive strong popularity and applicability within international trade, differentiating themselves from new emerging SCF techniques.

In January 2014, however, the Global Supply Chain Finance Forum was established to develop and publish a set of commonly agreed standard market definitions for supply chain finance and related techniques. A document entitled "Standard Definitions for Techniques of

Supply Chain Finance" was then published in March 2016 by ICC, the Banking Association for Finance and Trade (BAFT), the International Trade and Forfaiting Association (ITFA), Factor Chain International (FCI), and the Euro Banking Association (EBA) aimed at providing guidance to finance providers, their clients and regulators (Yap, 2019). The Standard Definitions were well recognized and accepted by the industry as a key step towards the standardization of terminology and the implementation of common practices for the trade finance industry (Hausherr and Trecker, 2019). The Global Supply Chain Finance Forum recognizes that SCF is an evolving set of practices that uses or combines a variety of techniques. Table 1 shows definitions and synonyms of supply chain finance techniques.

ICC additionally released the ICC 2018 Trade Register in June 2019, which marks an important step for SCF data collection and addressing SCF-related risk concerns. For the first time, the data set of the report covers SCF, specifically payables finance-related data. The inclusion of payables finance within the report reflects the major shift in trade finance from documentary trade to open account. The report stated that exposure-weighted default rates for SCF in 2017 were 0.11% (Hausherr and Trecker, 2019).

Table 1. Definitions and Synonyms of Supply Chain Finance Techniques

Techniques	Definition	Synonyms
Receivables Discounting	Receivables discounting is a form of receivables purchase, flexibly applied, in which sellers sell individual or multiple receivables (represented by outstanding invoices) to finance provider at discount.	Receivables Finance, Receivables Purchase, Invoice Discounting. Early Payment
Forfaiting	Forfaiting is a form of receivables purchase, consisting of the without recourse purchase of future payment obligations represented by financial instruments or payment obligations (normally in negotiable or transferable form), at a discount or at face value in return for a financing charge.	Without Recourse Financing, Discounting of promissory notes/bills of exchange
Factoring	Factoring is a form of receivables purchase, in which sellers sell their receivables (represented by outstanding invoices) at a discount to a finance provider (commonly known as the factor). A key differentiation of factoring is that typically the finance provider becomes responsible for managing the debtor portfolio and collecting the payment of the underlying receivables.	Receivables Finance, Receivables Services, Invoice Discounting, Debtor Finance
Payables Finance	Payables finance is provided through a buyer-led program within which sellers in buyer's supply chain can access finance by means of receivables purchase. The technique provides a seller with the option of receiving the discounted value of receivables (represented by outstanding invoices) prior to their actual due date and typically at a financing cost aligned with the credit risk of the buyer.	Approved Payable Finance, Reverse Factoring, Supplier Payments, Supplier Payments

Source: Global Supply Chain Finance Forum (2016).

2.2. Open Account

SCF can typically apply to open account trade which is one of the fastest-growing trade products.[3]

2.2.1. Character of Open Account

With global economies becoming more integrated with IT development, it has become easier for exporters and importers themselves to access dependable information about foreign-trade partners, and consequently, they are less willing to pay for the risk protection afforded by traditional methods. This has led to an increased preference for an open account.

Templar, Findlay and Hofmann (2016) found that the trade finance providers including banking and non-banking organizations, and factoring companies are developing solutions related to open account-related SCF techniques to meet the rapid growing demands of the market.

An open account is advantageous to the importer in terms of cash flow and cost, but it is consequently risky to an exporter. Buyers often press exporters for open account terms taking advantage of intense competition in export markets as summarized in Table 2 below.

Nowadays the extension of credit by the seller to the buyer is common worldwide, meaning that the exporters who are reluctant to extend credit may lose their importers or customers to their competitors who readily do it. Therefore to secure the payments from the importers, the exporters, prior to extending the credit, should thoroughly investigate the economic, political, and commercial risks as well as institutional differences regarding the importers and their countries. But due to their limited resources and desire to mitigate the risk of non-payment, the exporters too often resort to trade finance techniques such as export credit insurance[4] and international factoring. Exporters also often seek export working capital financing[5] to ensure that they have access to financing for production and credit period given to the buyer (Export.gov, 2019).

An O/A transaction refers to a transaction in which export receivables occur at the same time the exporter completes the shipment of the goods and notifies the importer of the assignment of receivables to a 3rd party(*i.e.* bank). Through the assignment of the receivables right after shipment, the exporter can cash the receivables earlier than the maturity agreed with the importer. The legal nature of the O/A receivable financing is that the exporter becomes the assigner of the receivable and the bank becomes the assignee of the receivable on condition that the assigner shall repurchase the receivables purchased by the assignee when payment is not made by the buyer. In O/A transaction, the exporter does not issue the draft but sends the original shipping documents to the importer directly.

Given this nature of O/A transaction, banks purchase shipping documents without

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[3] Boston Consulting Group estimates that open account trade will grow to more than 50% of total trade finance revenues by 2021, driven by banks expanding SCF solutions from large corporations to mid-market corporations and non-banks also offering SCF (Hausherr and Trecker, 2019).

[4] Export credit insurance protects against commercial losses (such as default, insolvency, bankruptcy) and political losses (such as war, nationalization, and currency inconvertibility). It allows exporters to increase sales by offering more liberal open account terms to new and existing customers. Insurance also provides security for banks that are providing working capital and are financing exports (Export.gov, 2019).

[5] Exporters who lack sufficient funds to extend open accounts in the global market need export working capital financing that covers the entire cash cycle, from the purchase of raw materials through the ultimate collection of the sales proceeds. Export working capital facilities, which are generally secured by personal guarantees, assets, or receivables, can be structured to support export sales in the form of a loan or revolving line of credit (Export.gov, 2019).

securitization of underlying goods, which is different from L/C transaction where the negotiating bank can recover the debts owed by the exporter, in case the issuing bank refuses to pay, by liquidating the goods held under the bill of lading which was endorsed by the exporter. The securitization of goods applies similarly to the purchasing bank in a D/P case when the buyer refuses to accept the documents or make the payment.

For this reason, banks are prudent in providing open account financing selecting only blue-chips or financially sound companies as their customers. For less creditworthy exporters, however, banks seek security arrangement like export insurance or request collateral from the exporter.

Table 2. Summary of Open Account

Time of payment	As agreed between an exporter and importer, net 30,60, 90-day terms, etc.
Goods available to buyer	Before payment depending on how the products are shipped and the length of journey.
Risks to seller	– Buyer defaults on the payment obligation. – Country or political risk of importer's country.
When appropriate to use	– The exporter has absolute trust that the importer will accept the shipment and pay at the agreed time. – Exporter is confident that the importing country will not impose regulations deferring or blocking the transfer of payment. – The exporter has sufficient liquidity or access to financing to extend deferred payment terms. – Used more regularly in international transactions to avoid high banking costs.
Financing	– Exporter finances the importer through usance payment terms. – Exporter may be able to obtain bank financing through an assignment of receivables. – Selling receivables on a non-recourse basis to a bank (factor) is possible

Source: Authors' own summarization.

2.2.2. Open Account Financing Based on Copy Documents

The transaction process of O/A financing is as follows.

① Banks first obtain basic terms and conditions of bank credit agreement together with credit transaction agreement, foreign exchange transaction agreement etc. and then conclude individual banking facility agreement with customers (being the exporters)

② In order to secure the assignment of receivables, the banks ask the exporter to insert 'Standing Payment Instruction' in the invoice that the buyer shall pay the invoice amount to the bank, being the new assignee, directly.

③ The banks then obtain documents such as copy of B/L and/or export license to ensure that the underlying goods are really shipped or finished customs clearance.

In O/A transactions, only copy documents including transport documents are presented. Therefore, in this method, the banks have much more difficulty checking the documents than in the letter of credit in which the original documents are to be presented. This is also true

with BPO (Bank Payment Obligation), standby LC, and demand guarantee where original shipping documents are not usually required. Among them, BPO is an irrevocable undertaking given by an obligor bank (typically a buyer's bank) to a recipient bank (usually the seller's bank) to pay a specified amount on an agreed date under the condition of successful electronic matching of data according to URBPO (Uniform Rules for BPO) adopted by the International Chamber of Commerce in 2012.

With regard to document checking, Article 12 of the URBPO stipulates that banks shall not be liable or responsible for the falsification of information presented by the exporter. Although BPO was introduced to cover the buyer's credit risk amid increasing open account payments, it has not been widely used worldwide and there is no transaction record of it in Korea.

Even in the case of original shipping documents, article 34 of the UCP, in which the original documents are presented, stipulates that banks shall be exempted from forgery of documents or legal effects. As to the forgery, ICC (ICC Official Opinion) further defined that the purchasing bank should be responsible for the forgery of the documents only if the purchasing bank itself was the party to the forgery of the bill of lading, or if it was aware of or did not pay reasonable attention to the forgery before presenting the documents, for example, if the forgery were apparent on the face of the document (ICC, 1980).

With regard to document examination, banks shall have reasonable time to review documents. For example, Article 14 (b) of the UCP600 stipulates that banks have a maximum of five banking days after the arrival of the documents for the document examination. In practice, however, most Korean banks do not strictly observe the rule taking the time for reviewing the documents just forwarding the presented documents to the issuing banks with only cursory checks. The reasons for this practice can be: the exporter wants to get a quick payment from the bank; the primary responsibility for document checking is on the issuing bank; the purchasing bank (ex, the negotiating bank) can exercise recourse to the exporters when the payment is denied by the issuing bank.

For these reasons, banks do not spend enough time on document examination but rather prefer, in providing export finance, large or creditworthy companies that are easier to exercise recourse against. Otherwise, they seek securities such as export insurance like K-Sure for less creditworthy SME exporters, who too often make requests for urgent invoice discount under open account transaction.

2.3. Fraud under Open Account Trade

In O/A transactions, exporters and importers may commit trade fraud, respectively or both parties may conspire to do so. The trade scam for importers is to buy goods without the intention of paying for them. In other words, importers receive goods from exporters first and then disappear.[6] It is not easy for exporters alone to commit fraud in O/A transactions. This is because O/A transactions are often paid by the importer after checking the goods. However, in O/A transactions, there are many trade and financial scams in which exporters and importers conspire to sell false export receivables to banks. Therefore, the bank that buys

[6] Sometimes the first delivery is against cash to gain trust. If for the next delivery, the credit granted is for 30 or 60 days, for example, there is enough time for the buyer to receive the goods, re-sell them and disappear. Another case is that goods are ordered in the name of a third buyer with a good rating, but a different (fraudulent) delivery address is provided. Other fraudsters order deliveries from as many suppliers as possible within a very short time frame, usually small deliveries but representing a much larger total (Global Trade Review, 2016).

O/A export receivables and K-Sure which provides export insurance must fulfill their due diligence in accordance with their role and nature in the transaction. With modern technology, creating a fake website or fake trade documents has become relatively easier and inexpensive. Banks and ECAs may apply a different level of due diligence[7] depending on the nature of their role in the transaction. Table 3 summarizes the main types of international trade fraud.

Table 3. The Main Types of International Trade Fraud

Type	Meaning	Remarks
Phantom Shipping	No goods are shipped and all documentation is completely falsified.	
Inferior Quality Goods Shipping	Sending rubbish or inferior quality of goods instead of the contracted goods.	
Back Date	The date of shipment is fraudulently altered or a false date is entered on the B/L to show that goods have been loaded within the contract period	to meet LC condition
Clean B/L for Damaged Cargo	The seller obtains clean B/L for damaged cargo from the carrier by submitting a letter of indemnity to the carrier and then sells the B/L to an innocent buyer.	
Forged B/L	The buyer may present a forged B/L to the carrier to obtain delivery of the cargo without payment for the goods.	
Multiple Invoicing	By issuing more than one invoice for the same goods, an exporter can justify the receipt of multiple payment	
Forged LC.	The seller and buyer conspire to defraud negotiating/ paying bank, or the seller induces the buyer into sending goods on the strength of a fraudulent LC.	
Over Invoicing	By misrepresenting the price of the goods in the invoice and other documentation (stating it at above the true value), the exporter gains excess value of the payment	
Under Invoicing	By misrepresenting the price of the goods in the invoice and other documentation (stating it at below the true value), the importer gains excess value of the payment	
Deliberate Obfuscation of the Type of Goods	In order to avoid regulations such as export or import bans, parties may deliberately disguise or falsify the type of goods	

Source: Authors' own reconfiguration and Coedell et al. (2014).

[7] Due diligence is the investigation or exercise of care that a reasonable business or person is expected to take before entering into any agreement or contract with another party, or an act with a certain standard of care (Wikipedia, 2019).

3. Analysis and Evaluation of Court Decision on Moneual Case

3.1. Fact Summary

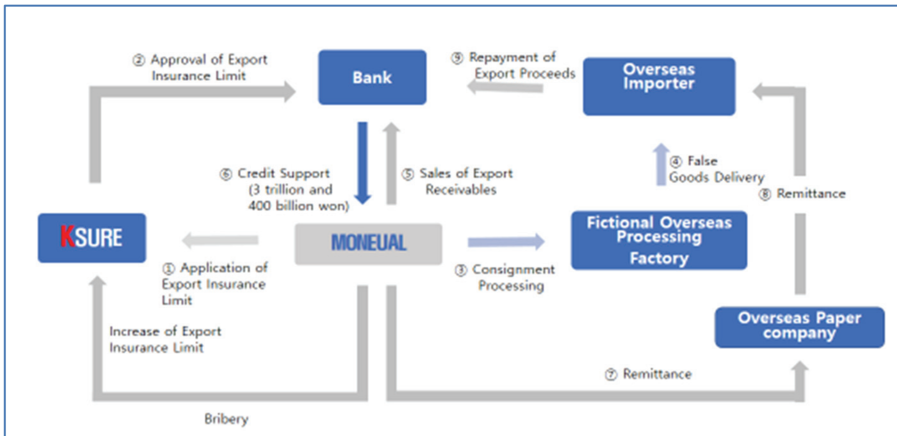
Moneual, a mid-sized company established in 2004, was known to manufacture and export TVs and PCs, and was designated by Korea Exim Bank in 2012 as a promising company to be named as a Hidden Champion, but most of its sales by the book turned out to have been falsified. At first, Moneual inflated the price and received trade finance, and later they got a discount on export receivables at 6 banks with fake shipping documents without conducting actual shipments. Total amount of the fake export was revealed to be 3.4 trillion won, some of which they repaid anyhow, but for the remaining 314 billion won approximately, the 6 banks were not able to retrieve. Moneual issued false inland transport documents stating that the goods assembled at the Hong Kong assembly factory were delivered to the importer in Hong Kong without actually delivering the goods, or they issued a false bill of lading abroad. However, it was not easy for the banks, K-Sure and customs authority based in Korea to detect the possibility of fraud at that time since 76% of the false exports were performed outside of Korea, i.e. from Hong Kong to the U.S.

Moneual, then, transferred the discounted export proceeds to the U.S. importer – accomplice of Moneual - through its paper company overseas, and the U.S. importer remitted the money back to the bank. The fraudulent process was repeated smoothly for a considerable period of time until the cash flow came to a deadlock in which the U.S importers were not able to remit the money to the bank any more.

Moneual signed up for EFF for liquidation of export receivables to K-Sure in order to get an easy discount on O/A export receivables from the banks. Believing that there were no credit risks involved in discounting the O/A export receivables of Moneual as they were covered by K-Sure, the banks readily discounted them without hesitation.

When the banks realized that they would not be able to recover the money from the importer, they filed insurance claims against K-Sure, which refused to pay the insurance money, declaring that the banks are at fault for not detecting false exports. As K-Sure argued, "the documents Moneual presented to the banks in application for the discount of the O/A

Fig. 1. Structure of Trade Finance Fraud in Moneual Case



Source: Authors' own configuration.

receivables contained conflicting statements, so banks should have suspected it was a false export." For example, the issuing date of the purchase order was later than the issuing date of importer's delivery request. Also, domestic inland transport document in Hong Kong indicated Incoterms 2010 DDP, though the export was not subject to customs clearance since it was done domestically.

Meanwhile, investigations of the Korean Prosecution Office revealed that Moneual illegally lobbied K-Sure to get an increase in the export insurance limit, and that the officials involved were subject to criminal charges and penalties. Fig. 1 summarizes the structure of trade finance fraud in Moneual Case.

3.1.1. Parties

Plaintiff: Commercial banks including IBK, Hana, Soohyup, NACF
Defendant: K-Sure
Exporter: Moneual Inc.
Importer: Several foreign buyers such as CNBM, NEWEGG, ASI
The underlying contract between plaintiff and defendant: EFF
Payment method between the exporter and importers: Open account
Products: Home theater PC products, etc.
Transaction: Moneual assigned their export receivables to banks on a without recourse basis where K-Sure provided its EFF to banks against buyer's non- payment (credit) risk.

3.1.2. K-Sure and Insurance Products

K-Sure was established to cover risks arising in trade transactions following a Trade Insurance Act. It deals with various export insurance products to promote the nation's export activities. Among these, export credit guarantee (post shipment), short term export insurance (post shipment), and EFF, among others, are often used by exporters in financing from commercial banks with the following schemes.

a) Export Credit Guarantee (Post Shipment)

As Fig. 2 (A) shows, in export credit guarantee (post shipment), banks purchase shipping documents from the exporter with the support of export credit guarantee which can be regarded as collateral. In case the importer fails to pay the advances to the bank, K-Sure makes reimbursement to the bank upon claims.

b) Short Term Export Insurance (Post Shipment)

As Fig. 2 (B) shows, short term export insurance (post shipment) is a system in which an exporter becomes an insurance policyholder by entering into an insurance contract with K-Sure, and K-sure compensates for losses incurred when the exporter does not recover the export amount. More often than not, the exporter assigns the right to claim insurance to his negotiating banks, which K-Sure pays to the banks with claim rights.

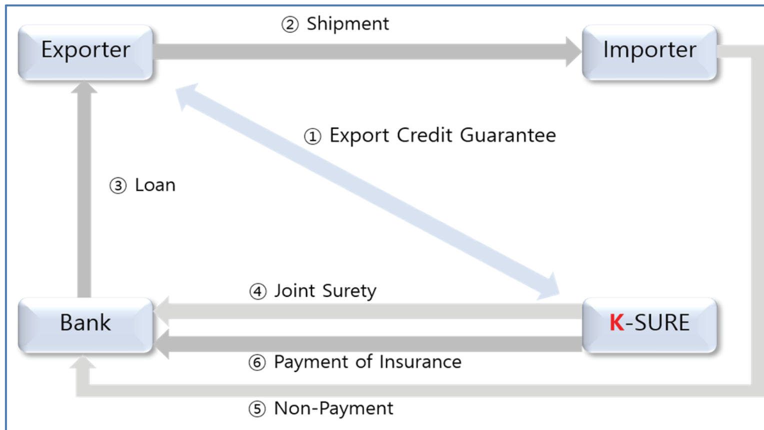
Rather than being the assignee of insurance claims for short-term export insurance, banks prefer to provide trade finance after obtaining export credit guarantee with narrow scope of exemption for K-Sure. However, as of October 4, 2016, the export credit guarantee agreement was amended to have a credit guarantee relationship established in O/A export receivables only if banks provide trade finance after requisitioning documents proving the receipt of goods by importers, thereby expanding the scope of the exemption for K-Sure. As a result of this amendment, not much difference exists in the scope of exemption for K-Sure between export credit guarantee and short term export insurance.

c) Export Financing Facility

As Fig. 2 (C) shows, under EFF, the bank becomes the policyholder by entering into an insurance contract with K-Sure. Relying on K-Sure's 100% compensation, several banks discount the open account receivables on a without recourse basis[8]. EFF is not a guarantee but an insurance.

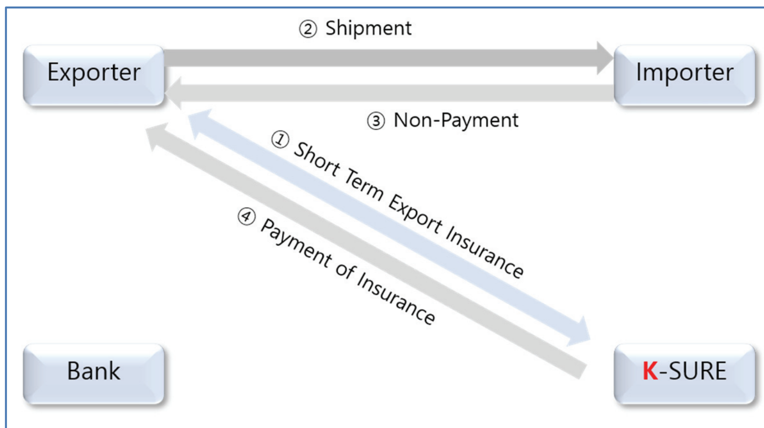
Fig. 2. Insurance Product of K-Sure

A: Export Credit Guarantee (Post Shipment)



Source: Authors' own configuration

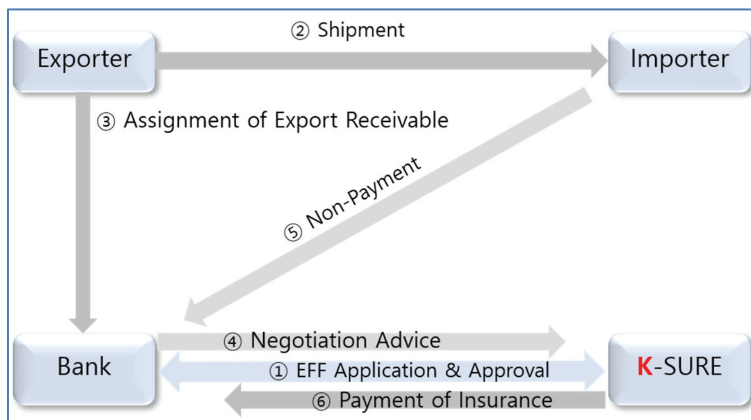
B: Short Term Export Insurance (Post Shipment)



Source: Authors' own configuration

[8] The term "without recourse condition" means that an insurance policyholder does not call repayment from the exporter, except in the case of the exporter's responsibility, even if the payment is not recoverable (K-Sure, Article 3 of EFF Agreement).

C: Export Financing Facility



Source: Authors' own calculation.

K-Sure initially either underwrote the short term export insurance or provided export credit guarantee, but later only underwrote EFF from 2010 in relation to Moneual's export transactions.

3.2. Argument of Plaintiff and Defendant

3.2.1. Plaintiff Position

The banks argued that K-Sure should pay insurance for the following reasons.

First, there is no definition in the insurance agreement of the case as to whether "exports" means "real exports". There is no explicit stipulation on how to handle goods if they were not actually shipped or if the shipping documents were prepared falsely. Under Article 5 of the insurance agreement, the insurance relationship shall be established from the date of exportation if the policyholder purchases and notifies the defendant of the export receivables discount.

Second, K-Sure revealed in their "2013 trade insurance exemption and recovery case book" that under the export credit guarantee (post shipment), bank shall be exempted if the bank had reviewed the documents with its usual duty and purchased them without knowing that they were prepared falsely by the exporter. EFF is designed to drastically reduce K-Sure's exemption clauses which are incorporated in the short-term export insurance and thereby strengthening the banks' security. Therefore, the banks should be exempted in this case as well.

Third, the banks usually do not have enough time to review each process of actual trade transaction in their task of document checking. In general, serious trade finance banks take a risk-based approach, meaning that they aim to add appropriate controls where there is a risk (Sindberg, 2018). Therefore, they spend the least amount on large enterprises with good credit record or trade finance with export insurance, and longer on clients otherwise. Since Moneual continuously afforded an extension of the limit in the export insurance coverage from K-Sure, and was once selected as a Hidden Champion by Korea Exim Bank in 2012, the banks recognized it as a good medium-sized company with good credit record. It is therefore no significant fault of the banks that they were not devoted to checking the trade process and

reviewing documents thoroughly.

Fourth, K-Sure argues that the date of a purchase order and the Incoterms term (DDP) on domestic delivery documents issued in Hong Kong are signs of red flags. But, in case of bonded warehouse transactions, a purchase order may be issued after a delivery request. An exporter puts the goods into a bonded warehouse in the country of importation prior to taking the purchase order and delivers the goods in response to the purchase order (Kim Han-Soo and Park Sae-Woon, 1995). Global companies are taking advantage of the bonded warehouse transactions because they can save transportation costs and other formalities in transporting a large number of goods and placing them in the bonded warehouse at the import site when possible even before a purchase order is issued. And, Incoterms 2010 DDP terms can be used in international trade that is not subject to import customs clearance (ICC, 2013, 85).

Fifth, while the banks and certified public accountants were conducting on-site inspection on Moneual's Hong Kong assembly plant, it was difficult for them to notice Moneual's fraud at that time because 30 local people who were temporarily employed for that purpose were seemingly busy working at the factory, and 40,000 units of HTPC, which were revealed later to have no commercial value, were stacked and piled in storage so that they altogether might look as if the factory was in actual operation. K-Sure also conducted on-site inspection on the factory twice during 2012, but found no fraud at Moneual's side. Furthermore, as K-Sure continued to increase the guarantee limit against Moneual, the banks mistakenly thought it as a sign that Moneual's sales would continue to increase.

Last, it is not easy for Korean banks to obtain the credit information of the importers as they do not have enough overseas branches to do the job. However, K-Sure is in a better position to know the buyer's credit because it specializes in overseas credit investigation.

3.2.2. Defendant Position

K-Sure argued that the banks were not eligible for the insurance claim for not practicing due diligence.

First, the insurance contract is effective if the plaintiff purchases export receivables arising from a genuine export transaction. However, this insurance contract for the case was not effective since Moneual had neither shipped nor exported goods. In other words, the insurance covers the credit risk of the importer who would not make payment in “a genuine” export transaction. However, the export transaction in this case was “false”.

Second, the documents presented by Moneual to the banks contained contradictions that must have indicated red flag, and it was the banks' fault not to have found them.

Third, paragraph 3 of Article 13 of EFF agreement stipulates the due diligence of the policyholder, or the bank. In other words, the bank should take the same due diligence in purchasing export receivables as in purchasing export receivables that are not covered by export insurance. However, the bank did not find any discrepancy in the documents (red flags) out of carelessness when it purchased export receivables, which means that it failed to fulfill its due diligence under Paragraph 3 of Article 13. Therefore, K-Sure is under no obligation to pay insurance, as Paragraph 1 stipulates an exemption that K-Sure does not pay all or part of the insurance for losses incurred by the policyholder's failure to fulfill the due diligence obligation under Paragraph 3 Article 13.

3.3. Court Decisions

The banks separately filed lawsuits against K-Sure in Seoul Central District Court. In the first trial, the court's judgment differed among the various departments of justice, with some

ruling in favor of some banks (Hana Bank, Nonghyup Bank), and another against other banks (IBK, Suhyup Bank). In the second trial (Seoul High Court), all departments of justice issued an order of compulsory mediation that K-Sure pay 50 percent of the claim amount to the bank. The case was closed by the parties' accepting this mediation.

3.3.1. The Court of the First Trial (Hana Bank vs. K-Sure) (Korean Seoul Central District Court, 2016)

The court of the first trial ruled that the EFF agreement does not include a clear stipulation that false exports do not constitute effective insurance, and where the terms are not clearly provided, the terms must be interpreted to the benefit of the customer, so K-sure should pay USD 80.8 million to the bank.

The court said, under the terms of the EFF, it can't be said that the meaning of "export" is "real exports".

3.3.2. The Court of the First Trial (Suhyup Bank vs. K-Sure) (Korean Seoul Central District Court, 2016)

The issue, in this case, was whether the bank fulfilled its obligation to pay attention during the loan process. The court found that the banks are responsible for evaluating export companies and export transactions (behaviors). The court said, "It is not the K-Sure, but the bank that collects the evidence to confirm the existence of the export insurance. It is the bank that makes sure whether an export transaction is real or whether it can recover the export receivables.

3.3.3. High Court (Suhyup Bank vs. K-Sure) (Korean Seoul High Court, 2018)

The high court issued a compulsory mediation order for the defendant to pay 50 percent of the purchase amount to the plaintiff, and the case was closed by both parties' accepting this mediation.

3.4. Evaluation of Court Decisions

The ruling of the court of the first trial regarding this case showed a wide difference depending on the court. These different court decisions may be due to their views on the extent of bank's due diligence and whether fake exports constitute losses that must be covered by export insurance. The issue also invited conflicting opinions among the academia.

Jung Gyung-Young (2017) and Seo Jung-Doo (2019) argued that EFF cannot be effective unless the export receivables exist, and therefore, K-Sure is not obliged to pay the insurance to the banks. On the other hand, Choi Byeong-Gyu (2016) and Han Ki-Jung and Choi Jun-Gyu (2016) argued that K-Sure should pay the insurance to the banks. They further argued that unless there is any clear provision on whether K-Sure should pay the insurance even in fake exports, the intention must be taken into account that EFF was introduced in order to reduce the risk burden on the bank's purchases of export receivables in O/A. Secondly, unless the insurance provisions are clear, they should be interpreted in favor of the customer (*Korean Supreme Court Decision*, 2009).

The high court did not make its ruling on the case but issued an order of 50:50 compulsory mediation. It seems that the court held the banks and K-sure equally responsible for the failure to detect Moneual's fraud, which made it difficult for either party to win the case.

3.4.1. International Banking Practice on Document Checking

In letters of credit transaction it is a universal principle that bankers deal only with

documents. This means that bankers view their role merely as checkers of documents under the terms of UCP600, and to ensure that the documents are compliant (Palmer, 2001). This principle is the basis for defining what degree of scrutiny and understanding a bank can bring to the identification of unusual activity involving a trade finance (Wolfsberg Group, ICC and BAFT, 2019). Although the criteria for document checking of L/C do not apply equally to O/A discounting by banks, it can be said that O/A discounting covered by export insurance are subject to checking practices similar to those for L/C.

Unlike the university labs, banks cannot afford to take enough time to check documents in a meticulous and investigating manner (Arai, 1974). Particularly in Korea exporters often present documents almost close to the bank's closing time, so the bankers are pressed to check the documents in only 3-5 minutes, which is an extremely insufficient amount of time for that kind of work.

3.4.2. International Factoring

Open account terms may be offered in competitive markets with the use of factoring, which is a financial transaction whereby an exporter sells its receivable, being the invoices, to a factor at a discount. With factoring, the finance provider (factor) becomes responsible for managing the debtor portfolio and collecting the payment of the underlying receivables (Global Supply Chain Finance Forum, 2016). Guillermo (2013) explained different types of factoring schemes such as domestic and international factoring, recourse and non-recourse factoring, confidential or non-notification factoring, etc. When the exporter and importer are located in different countries, factoring may be subject to General Rules for International Factoring (Factoring Chain International, 2013).

According to Oh Won-Suk and An Yu-Shin (2016), EFF was designed along the structure of international factoring. In Article 28 of FCI General Rules for International Factoring (2013), exporter factor undertakes that export receivables are based on actual shipments of exporter, so exporter factor can claim the exporter a refund in case there is a fraud.

Concerning representations, warranties, and undertakings, Article 28 (i) (a) of FCI General Rules for International Factoring (2013) stipulates;

(i) The export factor warrants and represents for himself and on behalf of his supplier:

(a) that each receivable represents an actual and bona fide sale and shipment of goods or provision of service made in the regular course of business and conformity with the description of the supplier's business and terms of payment

Had K-Sure assumed that commercial banks conduct the receivable purchasing as export factor and reflected this kind of clause in the EFF, they could have come out stronger with the commercial banks' breach of warranties. Unfortunately, measures like the above terms and conditions were missing in the EFF arrangement with the banks in Moneual case.

As for international factoring transactions which are actively conducted in the EU, the factoring industry in the EU provided over €217 billion of working capital financing to more than 200,000 businesses in 2017. According to the results published in EU Federation Factoring & Commercial Federation (2019 a), most SME businesses in the manufacturing, services and distribution sectors used factoring which is a financing solution with low Loss Given Default (LGD). The total turnover for factoring across the EU in 2018 was 1.7 trillion Euros, representing 10.9% of EU GDP in 2018 (EU Federation for the Factoring and Commercial Finance Industry, 2019 b). The development of factoring industry is spurred by demand for this safe and secure form of open account trade finance and driven by commercial bank owned factoring company (Mulroy, 2017).

On the contrary, in Korea, exporters rarely use international factoring. This is because costs

of international factoring are higher than getting EFF from K-Sure and discounting export receivables at banks in Korea. Besides, export factors may advance only about 80% of the invoice value to exporters while in open account financing, banks may advance 100% of the invoice value to them.

In these circumstances, the EFF came out in the market with full support of K-Sure against Korean banks' open account financing.

4. Control Mechanisms for Anti-Fraud

4.1. Bank's Due Diligence Policy

Banks should have risk-based policies and procedures covering customer due diligence, whereby all customers of the bank will be subject to the bank's customer due diligence procedures. Due diligence information ought to be made available to all departments handling trade finance, to enable them to understand the customer status including expected activity and identify further potentially suspicious activities (Wolfsberg Group, ICC and BAFT, 2019).

Due diligence is hard to define and its true meaning may be subject to variations from case to case. The concept of due diligence has its roots in the legal concept of 'a duty of care', which is better described as a 'duty to enquire further' throughout transactions where enquiries should be made (Palmer, 2001).

In this respect, BIS (2001) recommends that banks develop clear customer acceptance policies and procedures, including a description of customers that should not be permitted to open accounts. To minimize bank's risk, 'know your customer' (KYC) and 'customer due diligence' (CDD) procedures are required. KYC refers broadly to the initial gathering of information, while CDD broadly refers to the assessment of the information gathered and continuous monitoring (Cowdell et al., 2014). Procedures should be in place for verifying the identity of new customers; banks should never enter into a business relationship until the identity is satisfactorily established (BIS, 2001, paras. 17-19). A bank should also undertake regular reviews of its customer base to ensure that it understands the nature of its accounts and the potential risks (BIS, 2001, para. 20).

The better a bank knows its customers and understands the basics of its commercial relationship with them, the less likely it is to be associated with a firm that will attempt to commit export fraud.

Meanwhile, the enforcement of due diligence and anti-money laundering regulations by overzealous governments around the world has caused many banks to withdraw from trade finance business. This has resulted in a severe shortage of trade finance worldwide.

Therefore, it is reasonable that the banks exercise more extensive due diligence and closer monitoring on customers and transactions with higher risk. Banks should establish guidelines as to the extent of due diligence in a trade finance transaction (Monetary Authority of Singapore, 2015). The newly added appendices of Wolfsberg Trade Finance Principles (2019 amendment) address, among other things, the challenges relating to KYC requirements for open account transactions (Huasherr and Trecker, 2019).

4.2. Transaction Monitoring

Most of the time Moneual presented forged documents to the banks for discounting without making actual shipments. But the banks at that time, in general, neglected their obligation of transaction monitoring and failed to check if Moneual had made actual

shipments as indicated. Besides, Moneual cleverly made their shipments appear to take place abroad, for example, from Hong Kong to the USA, for the purpose of deterring the banks from checking the shipments. As a result of this fraud case and accompanying loss of tremendous amount of money, banks came to establish their internal guidelines for O/A customers which include cross checking with liners and customs services for the shipment indicated in the B/L and export declaration, respectively.

Banks are recommended to pick up the bill of lading presented to them at random from their good or not so good, large or small, new and old customers and have them checked at regular intervals. Such checks can be carried out free of cost by the ICC Commercial Crime Service[9] for their banking members (ICC Commercial Crime Service, 2002). IHS Markit also provides similar vessel checking service as ICC Commercial Crime Service does.

As the importance of vessel checking in investigating fake export becomes widely recognized, ICC Banking Commission Financial Crime and Policy Group is preparing to publish document relating to the bank's vessel checking standards.

Banks are particularly required to take greater caution in reviewing the transport documents issued by NVOCC[10]. According to IMB, NVOCCs issued more than 90% of all suspect bills of lading identified at its database. These suspect bills of lading are presented to banks in order to commit fraud, or money laundering and to bypass sanctions (ICC Commercial Crime Service, 2019).

An IMB spokesman said, "Incidents of ship owner/carrier or their agents issuing false B/L are uncommon because they take a big risk in doing so and open themselves to legal action, However, unlike the carriers or their agents, the majority of NVOCCs do not have any real assets at risk in these transactions except for their reputations" (Corporate Fair Trade Community, 2019).[11]

Another way recommended is to use the customs service website (http://unipass.customs.go.kr) to check the authenticity of the export declaration and confirm the history of loading onboard. This method, however, is not recommendable and feasible in the case of trilateral trade when the shipment is made outside Korea.

Banks should be alert and pay extra attention to the following red flags when processing trade finance of their customers as they could be indicative of fraud purposes:

- Discrepancies between the value of the invoice and current market value of the product
- Contradiction in the presented documents
- Inconsistencies in addresses such as different addresses used for the same parties, or one address used for different transaction parties.

The most common red flag of trade finance fraud is over-pricing. Therefore, ICC has suggested that banks check for remarkably unusual pricing to prevent false export. This price checking, however, is extremely challenging for banks to carry out when processing trade

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[9] ICC Commercial Crime Services (CCS) is the anti-crime arm of the International Chamber of Commerce. Based in the UK, CCS is a membership organization tasked with combating all forms of commercial crimes.

[10] NVOCC stands for Non-Vessel Owning Common Carrier. NVOCC operation comprises sales, stuffing, and transport of the containers to gateway ports. The agents of NVOCC take care of the bill of lading issue and overseas distribution.

[11] On January 15, 2019, ICC International Maritime Bureau launched its Non-Vessel Owning Common Carriers (NVOCC) Register and Code of Conduct. The purpose of the NVOCC Register is to improve anti-fraud standard and provide a mechanism to recognize participating NVOCCs who adhere to a minimum standard of anti-fraud measures.

documentation (ICC Knowledge Solution Department, 2019).

The bank can look up the unit price statistics by item using the Export-Import Statistics Information Service of Korea Trade Statistics Promotion Institute. The unit price, however, is nothing but a simple statistic based on the information on the unit price of export declaration by item. So it can be misleading to rely absolutely on the price. Hence, an apparently different price should not necessarily be considered abnormal.

Banks may also find it an extremely complicated and fallible job to check the consistencies and detect discrepancies of documents presented to them. Owing to the growing importance of trade based money laundering and sanction compliance in trade finance, global banks have introduced systems using OCR (Optical Character Recognition) and AI to facilitate their job effectively, which can also be used to detect red flags in trade finance.[12] KEB Hana Bank, among Korean banks, is preparing to introduce the system.

4.3. Block Chain and Smart Contract

The advent of block chain technology is on the verge of revolutionizing trade finance threatening to leave behind any financial services company that doesn't keep pace with the times. With use of blockchain technology, each leg of a transaction can be recorded and traced, making the ultimate destination and use of the funds clearer. This means reducing trade finance fraud becomes easier (Jenkins, 2016). Revolutionizing trade finance can be a complex pursuit, but a few financial services companies and block chain providers have already introduced trade finance block chains out of the labs to the marketplace. For example, HSBC has financed its first transaction in June 2019 on 'we trade', a block chain-based platform for open account trade in Europe (Global Trade Review, 2019).

The block chain is also being used in trade finance under letter of credit. For example, In transaction with a Taiwanese company under letters of credit, China Construction Bank is using its block chain platform's core functionality (L/C, forfeiting and international factoring) and Industrial and Commercial Bank of China is partnering with one of Africa's largest banks (Ford, 2019 a). HSBC has completed what it claims to be the first letter of credit pilot transaction on a live block chain in Malaysia (Ford, 2019b).

Korea Customs Service is also reported to introduce the block chain for customs administration, and the agency will supposedly build information networks connecting subjects of supply chain through block chain technology and share information in real time to prevent trade finance fraud and smuggling (Shin Ji-Hye, 2018).

Trade finance using block chain is based on a smart contract, a computable and digitally signed agreement between two or more parties. Through block chain, all documents relating to a specific object, such as shipping documents, verification certificates, origin markers, insurance certificates, etc., can be converted into digitalized assets. In this way, real-time visibility of trade information and cargo information can be obtained. This smart contract-based Fintech is expected to be realized in the near future.

Several attempts have been taken to digitize trade finance, but they have not gained sufficient take-up to practically reduce efforts in manual data entry and paper consumption across the industry. The latest initiative in this area of ICC is "digital trade ecosystems" – a digital platform that connects entities within the trade finance network and facilitates the flow of data between them. Consortia of banks and other larger players in trade finance are investing in their development (Boston Consulting Group and ICC, 2019).

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[12] IBM Watson, Pelican and SAS are developing systems using AI and machine learning to detect fraud and money laundering in trade finance.

4.4. Setting a Manual for Due Diligence of K-Sure

K-Sure (being ECA) is to consider issuing export insurance up to 90% of the invoices (receivables) to banks. This is to share financial risks coming from crimes with their customers awakening the due diligence on the part of their customers. The 90% rule is often employed by factoring companies. As for factoring, the accounts receivables are purchased by the factor that assumes the credit risk normally without recourse to the seller. The seller's customers (being the buyer) are usually notified to make payment directly to the factor. In some instances, buyers are kept ignorant of the arrangement and payments are made to the seller on non-notification basis. The seller (being exporter), entering into a factoring agreement, not only contracts to sell its receivables to the factor but also relieves itself of the credit and collection function which are assumed by the factor for a fee. When a business is being factored with notification, it shows on its invoices a notice that payment for the goods is to be made to the factor. The EFF was designed to support 100% of the invoice which is discounted by banks and therefore, the banks easily accommodated the SME's receivables without making efforts to be a genuine factor. K-Sure, even though it is the nation's ECA, may adopt the international factoring rules and practices.

Apart from the international factoring concept, K-Sure shall reconsider international trade credit insurance standards in which ECA typically covers between 85 to 95% for the buyer's credit risk and require the remaining risk to be retained by the insured party; such risk may be retained by the exporter, and/or held by the bank. This means that the balance of 5- 15% is typically either not discounted by the bank or is financed by the bank with full recourse to the exporter (Global Supply Chain Finance Forum (2019a).

We also suggest that K-Sure, together with the world-class ECAs, share a blacklist by establishing ECA's big data or data mining to provide awareness on questionable companies. In addition, the ECAs must conduct due diligence for new companies in reference to the relationship between the policyholder (being exporter) and the buyer.

5. Conclusion

Trade finance has played a vital role in the global economy and will continue to do so in the future, as it can help settle the conflicting needs of the exporter and the importer. While the exporters would like to mitigate the payment risk from the importer by facilitating the receivables, the importers want to mitigate the supply risk from the exporter with an extension of credit on their payment.

The function of trade finance is to remove the payment and performance risks and simultaneously provide the exporter with accelerated receivables and the importer with extended credit through third party being the banks. This might be viewed as a stumbling block in the international scenario because of a variety of challenges making risk management more difficult and complex.

In any trade finance, the vast volumes of money and documents changing hands make the transactions vulnerable to attack from fraudsters. Therefore, adequate due diligence on new and existing customers is very important in preventing trade finance fraud. Without due diligence, banks or ECA can be subject to reputational, legal and concentration risks and can run into significant financial losses.

In the case of Moneual, the amount of financial loss for K-Sure and the banks ended up becoming larger due to the bank's careless negotiation of the exporter's fake O/A documents on a without recourse basis and K-Sure's careless increase of insurance limit. This case was concluded with court mediation during the appeal proceedings. If only EFF terms had clearly

stated that false export transactions do not constitute insurable interest, the outcome would have been completely different, and K-Sure would have been exempt from the liability.

In Korea, since the country is heavily dependent on trade, for credit and emerging risks that are difficult for exporters to secure, the government mainly operates the non-profit policy insurance system through K-Sure. Since the 2008 global financial crisis which challenged trade circumstances worldwide, K-Sure's insurance underwriting performance has been rising sharply to support and facilitate the Korean SMEs' export and finance with commercial banks.

On the other hand, export credit agency's financing support with extremely favorable terms would likely produce malicious exporters and lazy banks which are fully covered by insurance in spite of their negligent behavior. And this is sometimes true of Korea where the policy makers tend to disregard market mechanism. Therefore, it is recommended that the ECA consider reducing the coverage ratio of export insurance by benchmarking that of factoring.

As to the banks in Korea, the purchasing bank does not have the right to make a direct claim against the importer even if there is a normal export shipment, but only have the right to ask the exporter for a reimbursement. This shows lack of remedy other than a recourse when export receivables are not honored by the buyer.

Therefore, banks should take extra care in their document examination making meaningful checkpoints such as cross-checking of shipments with carriers and Customs. And, at the same time, the banks must either devise the authentic methods of providing trade finance on a clean firm basis or join the international factoring scheme, otherwise.

Moneual case led to the establishment of banks' internal guidelines for O/A customers. These guidelines include cross checking with liners and customs services for the shipment indicated in the B/L and export declaration, respectively.

Because false exports often contradict between documents or contracts, and tend to be overpriced, it is extremely important for banks to check the consistency between them. Yet, it is not only time-consuming but less accurate for them to do the job manually. Therefore, they should positively consider introducing a trade finance detection system using AI. Trade finance using smart contracts and block chain, like what HSBC does, is going to be a clean solution in the near future.

Further, it is suggested that government authorities, international organizations, banks, and trade logistics providers work together to counter the threat of trade finance fraud by requiring that all parties in the public and private sectors ensure data exchange protocols thus enabling banks and ECAs to get access to the information freely across borders.

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