



AML, CTF & Sanctions Guidance Part II

Subject: Invoice Finance

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Preface

This part of the AML, CFT & Sanctions Guidance comprises Invoice Finance specific additional guidance focused on ML/TF risks and complements the general Guidance in Part I. Specific sanctions risks related to Invoice Finance are not (yet) addressed in this part of the guidance and will be further developed. Please refer to Part I chapter 4 for the general section on Sanctions.

This part is incomplete on its own and must be read in conjunction with the main guidance set out in Part I of this AML, CFT & Sanctions Guidance. Please refer to the Preface of Part I for the applicable regulatory framework and the purpose and the scope of the Guidance.

14. Invoice Finance

Introduction and description of product

General

- 14.1 Invoice finance products are used to fund the working capital requirements of customers; these generally fall into two categories:
- Factoring agreements; and,
 - Invoice Discounting agreements.
- These can be operated on a Recourse or Non Recourse basis, and with or without disclosure of the assignment of the sales invoice to the customer's customers, the debtors.
- 14.2 Invoice finance products can be offered by banks, subsidiaries of banks or independent factoring or invoice finance companies. For this purpose the term financial institution used in this section should be understood to refer to all of the above.
- 14.3 Factoring is a contract between a financial institution and their customer where revolving finance is provided against the value of the customer's sales ledger that is sold to the invoice financier. The invoice finance company will manage the customer's sales ledger and will normally provide the credit control and collection services. The customer assigns all their invoices, as usually a whole turnover contract is used, after the goods or service have been delivered or performed. The financial institution will then typically advance up to 85% of the invoiced amount – the gross amount including VAT. The balance, less charges, is then paid to the customer once the debtor makes full payment to the financial institution.
- 14.4 Invoice Discounting is a contract between the financial institution and their customer where revolving finance is provided against the value of the customer's sales ledger. The customer will manage the sales ledger and will normally continue to provide credit control and collection services. The customer assigns all invoices, as usually a whole turnover contract is used, after the goods or service have been delivered or performed. The financial institution records and monitors this on a bulk sales ledger basis rather than retaining the individual invoice detail. The financial

institution will then typically advance up to 85% of the invoiced amount. The balance, less any charges, is then paid to the customer once the debtor makes full payment to the financial institution. The customer undertakes the collection of the debt under an agency agreement within the contract. The customer is obliged to ensure that the payments from debtors are passed to the financial institution.

- 14.5 Asset-Based Lending in the Invoice Finance industry would usually have the customer's sales ledger at the core of the facility. It is a contract between the financial institution and their customer where revolving finance and/or fixed amortising finance is provided against a 'basket' of assets – accounts receivables, inventory, plant machinery, property, etc.

Recourse and Non-Recourse agreements

- 14.6 Recourse agreements can apply to factoring or invoice discounting agreements. If the debtor fails to pay the amount due to the customer, then the financial institution will look to the customer for reimbursement of any money they have advanced against that invoice.
- 14.7 Non-Recourse agreements can apply to factoring or invoice discounting facilities. The financial institution effectively offers a bad debt protection service to the customer. If the customer fails to pay the amount due to the customer, due to insolvency, the financial institution stands the credit loss up to the protected amount, which is the value of the credit limit provided against the particular customer, less any agreed first loss amount.

International Collection Services

- 14.8 Assigned sales invoices may include overseas sales that require international collection services. When the financial institution is not able to undertake this cross border activity, it may partner with a collection company in the appropriate country. Different types of institutions can fulfil a role as collection company, dependent on the jurisdiction and their role.
- 14.9 The activities and associated risks are considered to be similar to correspondent banking albeit considered to be a lower risk, the financial institution being fully aware of the underlying transaction and the purpose of payment.

Customer Due Diligence

Who is the customer from AML perspective?

- 14.10 In the invoice finance provision the party with whom the financial institution holds a contract to provide finance is usually referred to as a 'customer' and the customer's customers as 'debtors'.
- 14.11 The identification requirements on which guidance is given in Part I, will apply to a financial institution's customers (i.e. the parties with whom it has a customer relationship). The customer will be a business entity; a public limited company, private limited company, partnership or sole trader.

Customer Due Diligence measures.

- 14.12 The CDD measures carried out at the commencement of the customer relationship and the ongoing due diligence are some of the primary controls for preventing criminals using invoice finance facilities. Financial institutions must carry out risk-based CDD measures to gain a full understanding of the customer and their business before opening a facility. This must include establishing expected activity patterns of customers and their business activities to meet the requirements set out in Part I.
- 14.13 The identity of the customer's debtors will normally only be obtained from the customer, as part of the understanding of that customer, without verification being required. The financial institutions risk appetite could determine that verification of the identity of some or all of the customer's debtors and subsequent filtering against applicable (e.g sanctions, internal, adverse media) lists will also be required under circumstances considered to be of increased risk.
- 14.14 In terms of money laundering, some invoice finance products are considered higher risk than others; in these cases, enhanced due diligence measures as explained in Part I are required.
- 14.15 Enhanced due diligence is appropriate in the following, but not exhaustive, list of situations:
- Where any party connected to the customer is a PEP. (See Part I);
 - When the customer is involved in a business that is considered to present higher risk of money laundering;

- A customer who carries a higher risk of money laundering by virtue of their business or occupation. Examples in the context of invoice financing could be;
 - A business with a high level of cash sales.
 - A business with a high level of cross border sales, including Import-Export companies.
 - A business selling small high value goods that are easily disposed of.
- 14.16 To assess whether transactions or activities meet expected or historic expectations, a financial institution could take into consideration the following elements:
- Size – monetary, frequency, etc.;
 - Pattern – cyclical, logical, frequency, amount, etc.;
 - Location – cross border, rationale, etc.;
 - Goods / Service – Type, Use, Payment norms, etc.
- 14.17 Monitoring aspects of enhanced due diligence should be set out in the financial institutions’s risk-based approach. It is likely they will include the following:
- More frequent and on-site inspections of the customer’s books and records, frequently called an ‘Audit’, with appropriate management oversight and action of any significant deficiencies.
 - More frequent and extensive verification, usually by telephone contact with the debtor, of the validity of the sale and invoice values.
 - Greater management supervision of these facilities.
 - Extended KYC.

Money Laundering Risk

Factors of increased and decreased ML risk

- 14.18 As with any financial service activity, invoice finance products are susceptible to use by criminals to launder money. Both Factoring and Invoice Discounting products facilitate third party payments and may therefore be used by criminals for money laundering activity. The different invoice finance products available vary greatly and the degree of risk is directly related to the product offering.
- 14.19 The susceptibility of the invoice finance sector at the traditional placement stage is very low. This is due to the low level of

physical cash receipts in the invoice finance sector, as the vast majority of debtors settle outstanding invoices by way of cheque or electronic payment methods.

- 14.20 The main money laundering risks within the invoice finance sector are payments against invoices where there is no actual movement of goods or services provided, or the value of goods is overstated to facilitate the laundering of funds. As stated, the level of risk will depend on the nature of the product. Factoring should be considered to be a lower risk than invoice discounting, in view of the fact that direct contact is maintained with the debtor. Invoice discounting would represent an increased risk of money laundering due to the 'hands off' nature of the product.
- 14.21 The following factors will generally increase the risk of money laundering for invoice finance products:
- Cross border transactions;
 - Products with reduced paper trails;
 - Products where the invoice financier allows the customer to collect the debt;
 - Confidential products;
 - Bulk products.
- 14.22 The following will generally be considered good practice to decrease the risk of money laundering for invoice finance products:
- Individual items (invoices, customers, receipts) being recorded and managed by the financial institution;
 - Collections activity being undertaken by the financial institution;
 - Non-recourse facilities;
 - Regular ongoing due diligence and monitoring including on-site inspections and verification of balances;
 - Regular transaction monitoring to detect unusual transactions.

Risk assessment

- 14.23 It is important that a financial institution within its control framework has developed robust procedures to monitor the money laundering risks. In particular, the financial institution must have proper procedures in place to establish the source of funds, for which regular credit risk checks will generally not suffice. (See Part I)

- 14.24 With extremely low levels of cash being transacted the susceptibility of the invoice finance sector at the traditional placement stage is very low.
- 14.25 Invoice finance products may be used to launder money at the layering and integration stages. However, there are a number of factors that make the invoice finance facility less attractive to the money launderer, they are:
- The high levels of contact between the financial institution and the customer, in terms of physical audits and visits, and of transaction monitoring;
 - The sophisticated IT monitoring techniques used to detect issues with the quality of the underlying security, consisting of the quality of the goods and the customers (debtors);
 - In the case of factoring the item by item accounting and regular direct contact with the debtors;
 - Focus on the debtors in terms of creditworthiness and assessment of risk.
- 14.26 A financial institution operating a full factoring agreement, with regular contact, monitoring and review of the third party transactions, may determine that the risk level of Factoring Agreements, due to the level and frequency of the mitigating controls is low.
- 14.27 The risks related to invoice discounting facilities, while generally considered higher risk than factoring facilities may also be mitigated through regular due diligence by the financial institution. A financial institution must consider the risk level based on its own risk assessment and risk appetite.
- 14.28 Cross border transactions represent an increased risk of money laundering. The nature of the agreement will lead to these transactions being managed in different ways. A financial institution may consider reducing the risk by working with reputable collection companies and performing adverse news and sanction checks.
- 14.29 In general, the normally low to medium risk of money laundering will increase with the reduction of the levels of intervention by the financial institution and the increase in size of foreign transactions through the account.