Document-based fraud is a real concern for the commodities industry. A lack of coverage in traditional insurance policies has been highlighted by recent financial losses sustained due to multiple pledging of the same underlying asset, through the use of fraudulent title documents and/or trade receipts. This issue continues to cause economic loss and uncertainty for lenders and traders.

This flyer explores the inherent risks resulting from commodity document fraud, and the benefits of managing those risks. We will also highlight some known limitations of traditional insurance policies and the development of an alternative solution that could complement a prudent risk management strategy.

A MATURE RISK

Documents of title, warehouse receipts, and financing based upon these (and the underlying assets they represent) have always proved problematic. Significant reliance is placed on the integrity of the supply chain, meaning that, when that integrity is compromised (or found lacking), the financial consequences can be significant.

Many will recall the days when bills of lading fraud regularly led to financial institutions finding just empty containers when they came to inspect their goods.

When these losses increased significantly several decades ago, the financial institutions crime insurance market was resolute in the face of such losses involving documents of title. They responded by excluding all such risks. As a consequence, a familiar (now standard) exclusion found its way into policies:

Any loss resulting directly or indirectly from any items which are or purport to be bills of lading, shipping documents, warehouse receipts, trust receipts, accounts receivable, or any other bills, documents or receipts similar in nature.

This exclusion initially resulted in some creative claims being brought under the “On Premises” provision. These were brought on the basis that the forged document was presented at the bank’s premises which, it was argued, given certain drafting lacunae (usually the capital “P” in Premises being in lower case), could have been anywhere.

However, these avenues were soon closed and activities involving documents of title were no longer covered, except in very limited circumstances.

THE CAUTIONARY TALE OF QINGDAO

Several decades on, and issues at Qingdao have resulted in headline-making losses in the region of US$3 billion. By way of background, in 2014, Chinese metal trading company Decheng Mining was discovered to have collateralised multiple loans, using the same single warehouse of metal commodities located at Qingdao Port in China.

The commodities (mostly metals), went missing or were subject to multiple pledges (as part of, inter alia, bank repo-transactions). Consequently, although banks held seemingly-genuine documents (for example, warehouse receipts), there were no actual underlying commodities.
Other banks were left with receipts where multiple pledges of the same commodity had occurred.

Post-Qingdao, there is evidence that risk management practices across the industry have improved, but international trade will always attract determined fraudsters.

Therefore, demand for effective insurance remains high, although traditional policies tend to disappoint by excluding the necessary cover.

Below are some limitations of contemporary cover, and possible solutions:

**ARE YOU ACTUALLY INSURED?**

Absent the “documentary exclusion”, one of the thresholds for cover under a crime policy is the requirement that the documentation must either bear a forged signature, have been fraudulently altered, or be counterfeit. It is important to understand the extent of these definitions, and therefore the inherent limitation of conventional crime insurance policies:

- **Forged signature** - The handwritten signing of the name of another genuine person without authority and with the intent to deceive. It does not include the signing of one’s own name, with or without authority. Therefore, if a fraudster signs the document with his own signature, the signature is not forged and the definition is not met.

- **Fraudulently altered** - A material alteration to a document (which is genuine) for a fraudulent purpose, other than by the person who prepared the document. Again, if the fraudster prepared the document and applied their own signature, the document would not be covered (as there was no fraudulent alteration to a genuine document). Therefore, the definition is not met.

- **Counterfeit** - The reproduction of an authentic instrument. Fictitious instruments that merely contain fraudulent misrepresentations of fact are not counterfeit. This appears to be the case with much of the Qingdao documentation. Yet again, it means that the definition is not met.

While there was (and still is) much confusion relating to some of the losses at Qingdao, there is clearly a suggestion that certain financial institutions were holding counterfeit warehouse receipts. (that is, fictitious instruments which contained fraudulent misrepresentations).

A further complication was that some financial institutions may have had genuine receipts for underlying assets, while other financial institutions held duplicate receipts over the same assets. This created multiple and false titles on those assets.

The standard exclusionary language and loss definitions and requirements meant that losses such as those highlighted by Qingdao would not be covered under a conventional financial institutions crime policy. The absence of a “physical loss” also frustrated claims brought under other traditional insurance covers, such as marine cargo policies.

**INSURANCE EVOLUTION**

The lack of an appropriate insurance policy response to Qingdao has led to an increased demand for a satisfactory insurance solution. As a consequence, key trade and investments banks worked closely with Marsh insurance brokers and the insurance industry, to promote a re-evaluation of insurers’ long-held exclusionary position, and a remodelling of the cover available to those financial institutions able to demonstrate robust controls.

Following extensive discussions, Marsh produced its new **Commodity Document Fraud Insurance (CDFI)** policy. This innovative policy recognises that insurers can play a key role in providing suitable risk transfer, so long as a proper allocation of risk management responsibility can be established (for example, financial institutions that purchase this cover cannot pass-on their due diligence responsibility).

This new policy is offered as standalone cover, but does, in part, represent a buyback of the restrictions described above. Additionally, it materially extends relevant areas of documentary fraud coverage beyond what has traditionally been available. Under the CDFI policy, cover is available:

- Where the document bears a forged signature, or has been fraudulently altered or fraudulently obtained
  – For example, the signature or authentication has been obtained from a genuine person by trick or deception.

- Where the document has been lost, stolen, or destroyed.

- Where the document is counterfeit
  – For example, a reproduction of any authentic instrument, or one which appears to be authentic.

- Where the document has been fraudulently issued – For example, it is a genuine document which contains a fraudulent misrepresentation of fact.
  This considerably expands the definition of counterfeit.

One further material departure from traditional forgery insurance is the provision of cover where the documents have been duplicated (for example, the fraudulent issuance or use of a document or a document which appears to be a commodities document) and creates a multiple pledge of the commodities.
In the event that the financial institution is not able to assert title to the commodities because another financial institution is able to assert superior title, the policy will respond.

Reflecting the commodities industry’s close involvement in its development, the CDFI policy terms and conditions reflect a more balanced coverage approach between insurers and the insured than is typically found in generic crime forms:

- Cover is extended to the activities of the financial institution’s agent: For example, the collateral management company, warehouse, storage or management company, or a party having “care, custody, possession, or control of the commodities”.
- The policy recognises that fraud can be committed via a broad range of documents in current use across the commodities industry.
- There is a considered, user-friendly proof-of-loss provision.
- There are no onerous basis provisions, and the proof of loss provision allows for improved product efficacy in real-world loss situations. The dispute resolution provisions are intended to bring any disputes to a speedy resolution.
- The tightly constructed insurance clause is allied with limited exclusionary language\(^2\).
- There is attribution of knowledge to specified persons/roles.
- Basis of valuation provisions includes cost of insurance, freight, and percentage uplift.
- There is blanket global coverage across all commodity classes.

**CONCLUSION**

Given intense bank trade finance activity in this area, fraud remains a key risk. Consequently, a considerable amount of interest has been shown in the new CDFI policy.

While the principal aim of insurance is to de-risk capital by the transfer of risk to a third party, certain sophisticated financial institutions may look at these types of operational risk policies to assist in achieving regulatory capital relief. This relief could be upwards of 20% with regard to operation risk capital, depending on the adequacy of the insured’s credit rating.

Specialised and focused insurance of this nature (which brings tangible risk offset) may also play a meaningful capital offset role supporting prudent risk management in reducing capital charges.

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1 Inevitably, the issues surrounding Qingdao have led to litigation (see, for example, Mercuria Energy Trading PTE Ltd and another v Citibank NA and another [2015] EWFIC 1481). Interestingly, Citibank, as the financier, insisted as part of the repo arrangement that it be noted as a co-insured. Not only does this assist a financial institution in obtaining the appropriate capital relief, but adequately drafted financier endorsements will give added protection should issues arise with regard to the principal named insured.

2 The exclusions cover the usual Lloyd’s standard boilerplate exclusions and risks which would be covered under other programmes. For example, an insured’s political risk insurance programme.
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