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LETTERS OF CREDIT

A comprehensive guide to Documentary Credits



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This is a jointly produced publication between the BAFT (Bankers Association for Financing and Trade) and Trade Finance Global (TFG).

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FOREWORD

Letters of Credit, the engine behind international trade

In the ever-evolving world of global trade, the role of traditional documentary trade instruments like Letters of Credit (LCs), also known as Documentary Credits, becomes increasingly pivotal. As we navigate through complex macroeconomic terrains and geopolitical uncertainties, LCs provide the industry with security and trust in international transactions.

Interest rates remain high across many economies, access to finance is becoming more difficult for many corporates, and multiple conflicts are leading to a rise in shipping costs and supply chain shortages.

More than 50 countries, accounting for over half of the world's population, will have elections in 2024. This geopolitical volatility could create significant problems for the world of international trade.

But the world has undergone many changes before and one of the main tools used for trade during times of turmoil has been, and always will be, the Letter of Credit.



It is important to break down such a vital component of international trade, which is why Trade Finance Global (TFG) and BAFT (Bankers Association for Finance and Trade) put together this guide to try to demystify LCs. We want more people to utilise the tool and continue to break down the barriers of international trade.

The continued relevance of LCs is highlighted by their increasing adoption, as documented by the International Chamber of Commerce's (ICC) 2023 [Trade Register](#).

This uptick in usage is not merely a reflection of growing trade volumes but also an

indication of the trust placed in LCs by businesses seeking to navigate the uncertainties of international markets.

The data points mentioned by the ICC's Trade Register point to a broader trend of reliance on formalised trade finance mechanisms to secure transactions in a landscape marked by fluctuating economic policies and trade tensions.

This guide is crafted to provide a comprehensive understanding of LCs, from their historical origins to their modern-day application. It aims to demystify the technicalities of LCs, offering insights into their operational framework, legal underpinnings, and practical usage in trade finance.

Whether you are a seasoned finance professional or new to trade finance, TFG and BAFT

hope that this guide will help you navigate the international trade world.

TFG and BAFT are thrilled to launch this LC guide at the [BAFT 2024 International Trade and Payments Conference](#) in Washington D.C. We want to thank David Meynell and Pradeep Taneja for their help in writing this guide, and the BAFT Letter of Credit Committee for providing their expertise and guidance during the process.



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1

Documentary credits (Letters of Credit): definition and purpose

Definition

Documentary credits are payment instruments that constitute a definite undertaking of the issuer (“the issuing bank”) on the instruction of the buyer (“applicant”) to pay a certain specified amount to a seller (“the beneficiary”) at sight or on a future determinable date (“the maturity date”) provided that documents stipulated in the documentary credit are presented in compliance with the stated terms and conditions.

The issuing bank issues the documentary credit on behalf of its customer (“the applicant”) or on its own behalf.

These undertakings are known as “documentary credits”, as they specify the documents that must be presented in order for the credit to be honoured.

These are also known as “letters of credit” (LCs) as they were originally issued in a physical document form addressed to the beneficiary with the issuing bank’s undertaking to pay upon receipt of complying documents.

There are several critical features of documentary credits:

Irrevocability : documentary credits constitute an irrevocable undertaking of the issuer to pay, meaning that, once issued, the credit cannot be revoked or changed by the issuing bank. A credit can only be amended or cancelled with the consent of the issuing bank, the beneficiary, and the confirming bank (if any).

Documentary nature : documentary credits are documentary in nature and any payment undertakings contained in them are conditional upon receipt of documents as stated in the terms and conditions of the credit.

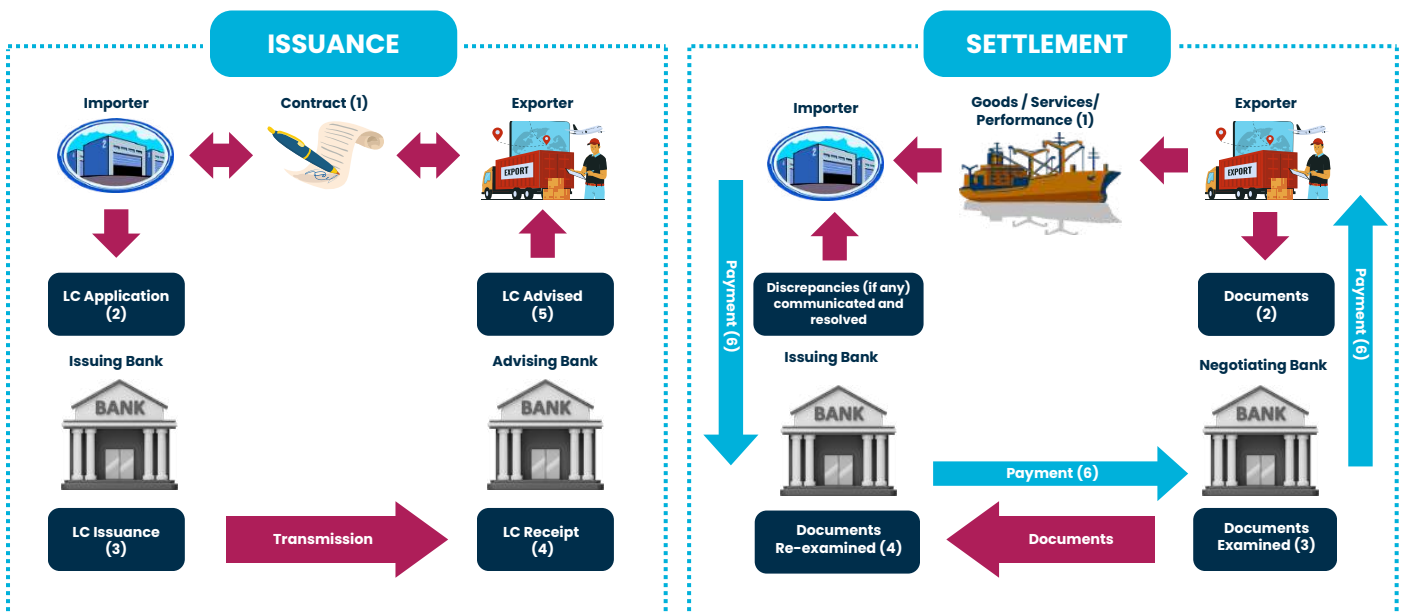
Compliance : documentary credits are settled only when the documents presented by or on behalf of the beneficiary comply with the terms and conditions of the documentary credit. Therefore, to obtain payment under a documentary credit, the beneficiary must present documents which comply with each credit’s terms & conditions. If the documents contained do not comply (also known as discrepancies), an issuing bank may refuse to honour and is only obligated to pay if the non-complying documents are corrected and made compliant before the credit expires, or if the applicant waives the discrepancies and the issuing bank also agrees to waive any discrepancy(ies).

Payment mechanism : documentary credits constitute a payment mechanism designed to facilitate the settlement of an underlying trade transaction whereby the applicant (the buyer) receives the goods or services, and the beneficiary (the seller) obtains payment via the credit which would then satisfy the applicant’s payment obligations against the underlying sales or other contract on which it may be based.

Independence and autonomy : documentary credits constitute an independent undertaking of the issuing bank and the confirming bank (if any) separate from the underlying sale or other contract on which it may be based. The principle of autonomy is articulated within the ICC Uniform Customs and Practice for Documentary Credits 2007 Revision (“UCP 600”) and is upheld throughout the world.



Documentary Credits – Process



Purpose

The purpose of a documentary credit is to provide a mechanism or arrangement to facilitate the settlement of an international or domestic trade transaction by use of a bank undertaking.

It should be noted that banks only deal with documents and not with goods, services or performance to which the documents may relate.

The terms and conditions of a documentary credit form the basis upon which the applicant must reimburse an issuing bank

when a complying presentation is made.

Documentary credits assure the beneficiary of payment as long as they present the requisite complying documents to the nominated bank, the confirming bank (if any), or the issuing bank.

2

Why use a documentary credit: Risk mitigation and benefits

Risk mitigation

International trade transactions often involve buyers and sellers residing in countries with different legal systems, currencies, market practices, customs, trade, and exchange control regulations.

Buyers can face challenges in evaluating the credibility of foreign suppliers and have to bear the risks associated with the seller failing to fulfil its contractual obligations. This can include non-delivery or delayed delivery of the goods or goods that do not meet the quality standards agreed upon in the contract.

Given the challenge of remedying these issues in a foreign and unfamiliar legal system, buyers naturally prefer to commit to making payment only after receiving the goods to their satisfaction.

Likewise, sellers must bear the risk of non-payment and, if that occurs, would need to take legal action against the buyer in the buyer's country. This means that sellers naturally prefer to receive payment before making a shipment.

This dynamic, where buyers only want to pay after delivery, but sellers want to receive payment before shipping, creates an imbalance in the system.



Documentary credits provide a mechanism to address and help resolve these conflicting interests.

UCP 600 and International Standard Banking Practice (ISBP) publication 821 govern documentary credits and provide the rules and practice for the examination of documents.

As such, when traders deal under the terms of a documentary credit, there is a reduced likelihood of misunderstanding or misinterpretation, which helps to minimise the risk of unforeseen disputes.

To avail upon the benefit of the documentary credit mechanism, it is vital for the



beneficiary to clearly state the terms and conditions of the documentary credit, including which documents are needed and which party should issue them.

Likewise, the beneficiary must submit the documents stipulated in the documentary credit's terms and conditions.

Benefits

The benefits of documentary credits differ depending on which side of the transaction a party finds themselves on. For the buyer in an international transaction (i.e., the applicant), the primary benefits are assurance that:

- 1 In most cases, they will only need to make payment after the shipment has been made.
- 2 The seller will submit the documents required by the credit which should allow for customs clearance needs.
- 3 The issuing bank will examine the submitted documents for compliance with the terms and conditions of the credit before payment is made.

For the seller in an international transaction (i.e., the beneficiary), the primary benefits of a documentary credit are that:

- 1 The risk of payment under the sales contract shifts from the buyer to the issuing bank (which may have a credit rating which exceeds the applicant's).

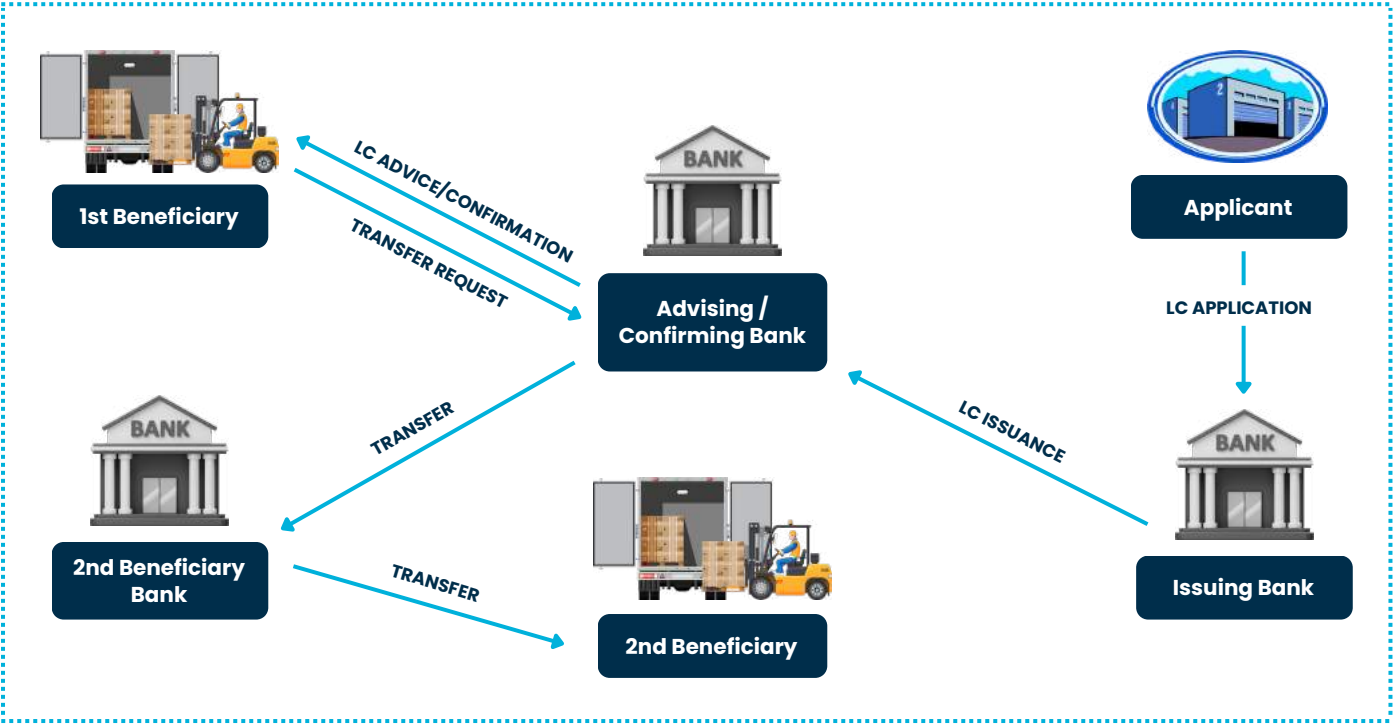
The credit is independent of the sales contract and in instances where a presentation complies with the credit, the issuing bank is obligated to pay. In the event they do not pay, for whatever reason, the seller can still rely on the sales contract from its buyer.

- 2 A documentary credit cannot be cancelled or amended without beneficiary agreement since a documentary credit is, by definition, irrevocable.
- 3 The issuing, confirming or nominated bank which agreed to act upon its nomination, if there is one, will make payment upon presentation to them of complying documents.
- 4 There is the possibility of further recourse to a confirming bank. (This is useful if the seller has concerns regarding the political, or legal landscape for the buyer's country or the credit rating of the issuing bank).

3

Parties involved

Transferable – Process



Several distinct entities can be parties to a documentary credit. Some must be present, while others are optional and only added to meet certain goals or requirements for the specific interaction. This chapter highlights the possible parties in documentary credits.

In its application, the applicant details the documents required under the documentary credit along with applicable terms and conditions. Even though the applicant initiates the request, it is not a party to the documentary credit since a credit is a bank undertaking.

The issuing bank irrevocably undertakes to pay the beneficiary upon receipt of the necessary documents as determined by the terms and conditions of the documentary credit.

The beneficiary

The beneficiary is the party in whose favour the documentary credit is issued. It is generally the seller in an international trade transaction.

The applicant

The applicant is usually the buyer of the goods who requests (or applies to) the issuing bank to issue a documentary credit on its behalf.

The issuing bank

The issuing bank issues the documentary credit as per the applicant’s request.

The confirming bank

A confirming bank can provide an irrevocable undertaking – in addition to that of the issuing bank – to honour the documentary credit.

This means that it agrees to pay at sight, or to incur a deferred payment undertaking, or to accept a bill of exchange (depending on the availability of the credit) on receipt of compliant documents as stipulated in the documentary credit's terms and conditions.

The advising bank

An advising bank receives the documentary credit from the issuing bank and advises the beneficiary on establishing its authenticity.

By advising the documentary credit, the advising bank verifies that the documentary credit is authentic and provides assurance that the advice accurately reflects the terms and conditions of the documentary credit as received. Unless the advising bank has confirmed the documentary credit, it assumes no further liability or responsibility.

The nominated bank

The issuing bank can authorise another bank, called the nominated bank, to pay a presenter at sight, to accept a bill of exchange, or to incur a deferred payment undertaking to pay at maturity.

Nomination by the issuing bank only imposes obligations on the nominated bank if it has confirmed the documentary credit or expressly agreed and communicated to the beneficiary that it will act on its nomination.

The reimbursing bank

The reimbursing bank is another party – usually the issuing bank's correspondent bank, with which the issuing bank maintains an account in the currency of the documentary credit.

The documentary credit will stipulate the name of the reimbursing bank on which the nominated bank or the confirming bank (then known as "claiming bank") should make a reimbursement claim.

The issuing bank authorises the reimbursing bank to honour a reimbursement claim from the claiming bank.

The reimbursement authorisation is often subject to the ICC Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits (URR 725). If not so indicated in the credit, reimbursement is subject to UCP 600 article 13 (Bank-to-Bank Reimbursement Arrangements).

The transferring bank

In some cases, the beneficiary is an intermediary trader that sources the goods from another supplier and may request its buyer to arrange a transferable documentary credit. The issuing bank would then nominate a transferring bank to transfer the documentary credit.

The beneficiary ("first beneficiary") will request the transferring bank to transfer the documentary credit in whole or in part to its own supplier (i.e., "second beneficiary").

For a transfer to occur, the documentary credit must explicitly state that it is transferable.

4

Types of credit



There are several types of documentary credits, each with its own characteristics.

Sight credits

With sight credits, the nominated bank (acting on its nomination), the confirming bank, or the issuing bank effects payment upon presentation of the documents (also called “at sight”), provided documents comply with the terms and conditions of the documentary credit.

Usance credits

Under usance credits, the issuing bank undertakes to honour a compliant presentation at a future date (known as the “maturity date”). There are two types of usance credits:

- 1 Acceptance credits:**
A documentary credit stipulating the presentation of a bill of exchange (“draft”) which the bank will accept and pay at maturity to the beneficiary.
- 2 Deferred payment credits:**
Same as acceptance credits, except that they do not require the presentation of a draft.

Mixed payment credits

Practitioners use mixed payment credits when a partial amount is payable at sight while the remainder is payable at a future date (or dates) as per the documentary credit terms.

Since these credits comprise a mix of sight and usance credits, they are known as mixed payment credits.

Negotiation credits

A negotiation credit is the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or documents under

a complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank.

Confirmed credits

Confirmed credits are those that also bear the confirming bank's irrevocable undertaking (in addition to that of the issuing bank) to honour or negotiate, without recourse, documents complying with the terms and conditions of the credit.

Transferable credits

If the beneficiary (i.e., the "first beneficiary") of a documentary credit is an intermediary trader that procures the goods from another source, they may request the buyer to provide a transferable credit, which the first beneficiary can then transfer to its supplier (i.e., the "second beneficiary"). A transferable documentary credit must expressly state that it is transferable and provide the name of the nominated bank or the bank authorised to transfer.

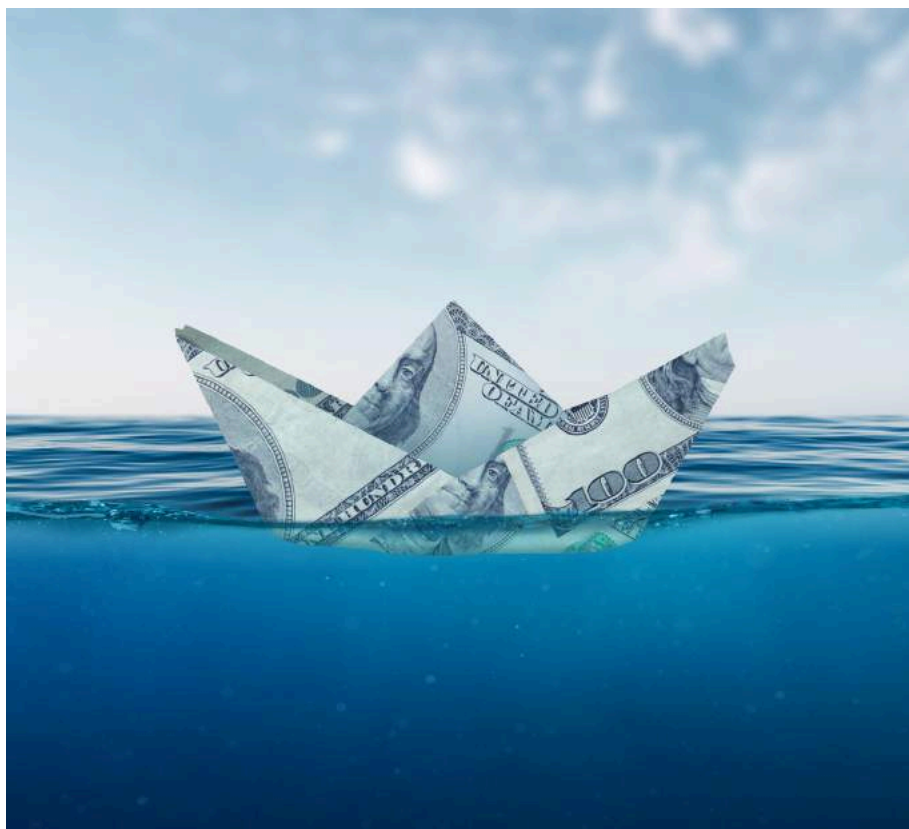
To transfer the credit, the first beneficiary will request that the nominated or authorised bank transfer the documentary credit to the second beneficiary in whole or in part.

The first beneficiary can request transfer to multiple second beneficiaries, provided the documentary credit allows for partial shipments. However, the second beneficiary cannot transfer the documentary credit to another subsequent beneficiary.

Under UCP 600, the transfer must be effected on the existing terms and conditions except for the amount, the unit price if given, the expiry date, and the latest date of shipment or period for presentation, all of which can be reduced. Furthermore, the name of the first beneficiary can be substituted with the applicant's.

If the documentary credit requires the presentation of an insurance document, the amount or the percentage of insurance can be increased to provide cover as initially required under the documentary credit.

The first beneficiary has the right to provide its invoice in substitution of the second beneficiary's invoice and draw for the difference in amount, if any. However, if it fails to provide its invoice, the transferring bank can forward documents received from the second beneficiary to the issuing bank.



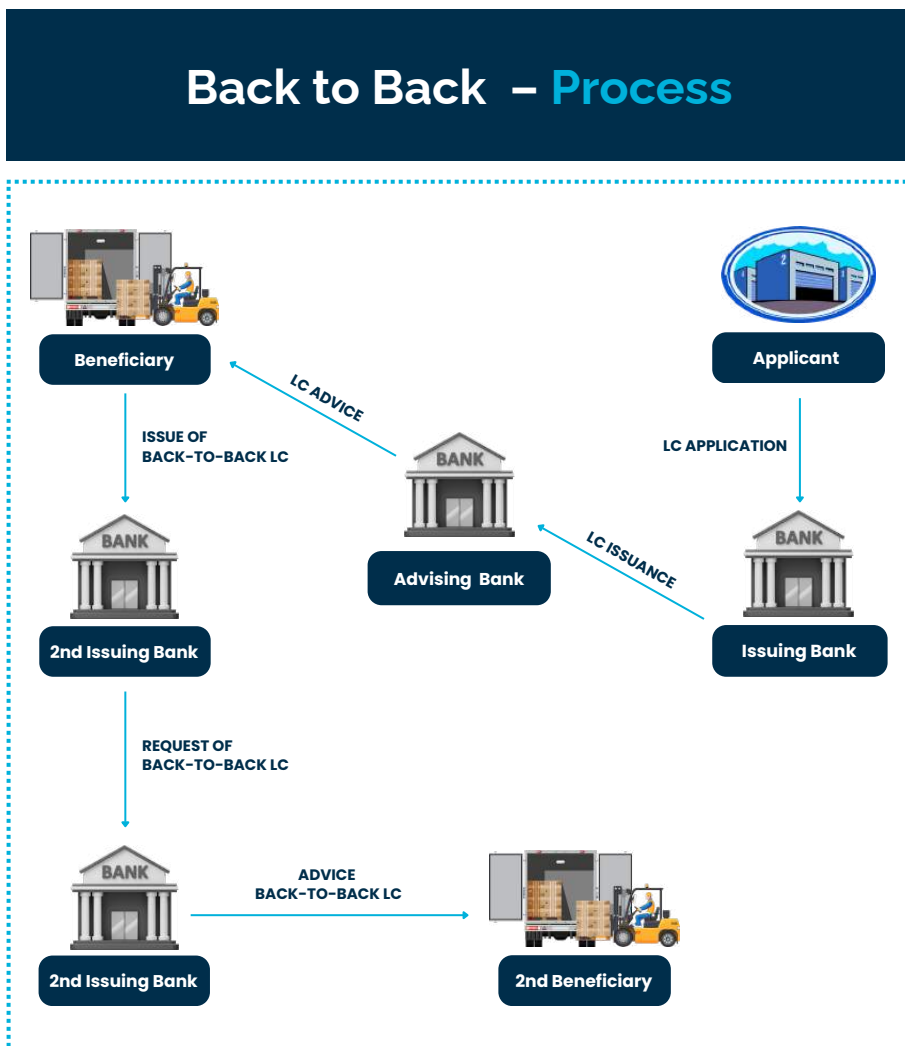


Back-to-back credits

Back-to-back documentary credits serve the same purpose as transferable credits.

However, instead of transferring the original documentary credit to its supplier, the beneficiary requests that its bank issue a new one in favour of its supplier. Practitioners call these back-to-back credits, as banks issue them on the back of an original documentary credit.

A back-to-back credit is separate and independent from the original documentary credit. While the issuing bank of the back-to-back documentary credit must honour a complying presentation received under its documentary credit, the payment under the original is contingent on the ability of the beneficiary of the original documentary credit to provide documents in compliance with the terms and conditions.



Instalment credits

Instalment credits stipulate a shipment schedule with specific quantities or dates by which the goods will be shipped.

A unique feature of these credits is that if one instalment is not shipped within the stipulated period, the entire credit is no longer available for any subsequent instalments (not just for that specific instalment).

Revolving credits

When buyers place repeat orders with the same sellers for the same goods at the same price and with the same terms and conditions, instead of issuing a new credit every time, they can agree with their suppliers to issue revolving credits.

These credits are 'revolved' – either automatically or through a notice of reinstatement from

the issuing bank – under the terms and conditions of the existing drawing.

The parties can agree to stipulate the number of times, the maximum amount, or the latest date up to which a revolving credit will automatically be reinstated.



Advance payment credits

Typically, documentary credits provide payments to the beneficiary at the post-shipment stage upon presentation of documents complying with the terms and conditions. However, it is possible to provide advance payment to the beneficiary at the pre-shipment stage in anticipation of the beneficiary presenting documents after shipping the goods.

To accomplish this, the credit allows the beneficiary to draw for up to a specified amount by simply presenting a receipt. The amount of any advance payment must then be deducted from invoice amounts as goods are shipped.

Financiers can provide pre-shipment finance through two types of advance payment credits:

- 1 Red clause documentary credits:** These credits contain a clause authorising the nominated bank to extend an advance payment to the beneficiary. The bank can release a set value at the pre-shipment stage to help the beneficiary procure the raw material, process, manufacture, pack, and export the goods. The advance

payment is settled later by the submission of credit-compliant documents by the beneficiary covering the relevant shipment of goods.

Banks historically typed this clause in red ink when credits were issued in letter form.

- 2 Green clause documentary credits:** These credits are similar to red clause documentary credits. However, in addition to extending advance payment to the beneficiary at the pre-shipment stage, green clause documentary credits also include additional coverage of pre-shipment warehousing and insurance costs.

Standby letters of credit

Standby letters of credit (SBLCs) are used for a variety of purposes, such as to support an applicant's performance obligations (performance standby), to support an applicant's bid in a tender (bid-bond standby), to guarantee an applicant's financial obligations to the beneficiary, which can also be a bank (financial standby), or to guarantee the performance of a commercial contract (advance payment guarantee).

Practitioners also use SBLCs to support open account transactions where a seller ships the goods directly to the buyer, and the buyer is expected to make the payment directly to the seller. If the buyer fails to pay when due, the beneficiary can draw on the SBLC.

Generally, standby credits are not expected to be drawn on, hence the name. SBLCs are akin to guarantees since, in the case of the applicant's default or non-fulfilment of its contractual obligations, the beneficiary of an SBLC can draw under the SBLC by claiming on the issuing bank or the confirming bank as per the terms and conditions of the SBLC.

Typically, the beneficiary's claim must be supported by documents such as its statement confirming the applicant's default, copies of unpaid invoices, or copies of transport documents as required in the SBLC.

Although many documentary credits are often issued subject to UCP 600, UCP 600 has limited applicability to SBLCs as not all articles of UCP 600 apply to SBLCs. The International Standby Practices of 1998 ("ISP98") (ICC publication no 590) provides a separate and exclusive set of rules governing SBLCs issued subject to ISP98.

5

Rules, practice, and law



Issuing a documentary credit is not always a simple formality or an act that can be completed in a standard or recurring manner. It often requires attention to detail by the corporate parties and, more importantly, to contain precise wording with a single interpretation.

Documentary credits are transactions prepared according to the specific requirements notified by an applicant, and such provisions should not be restricted to the name of a document but also extend to the data content for that document and, where appropriate, the name of an issuer.

An applicant should ensure that the instructions it provides to its bank for issuing any documentary credit meet the requirements for specifying the appropriate documentary obligations. This will enable the smooth importation of the goods and provide a suitable level of assurance regarding the quality, standard and type of goods purchased.

The content of the sales contract, proforma invoice, or purchase order agreed with the seller should, where appropriate, adhere to these instructions. However, banks will discourage any attempt by the applicant to include, as an integral part of the credit,

copies of the underlying contract, proforma invoice, or the like. Most documentary credit application forms incorporate a choice of the main types of documents under the terms and conditions. For example, they often include invoices, transport documents, insurance documents, packing lists, and weight lists.

Applicants are strongly encouraged to provide the name of an entity required to issue each document and its data content.

UCP 600

Over the years, the ICC Banking Commission has become a leading global rule-making body for the banking industry, producing universally accepted rules and guidelines for international banking practice.

ICC rules include the Uniform Customs and Practice for Documentary Credits, introduced to alleviate disparities between national laws on documentary credit practice. The ICC published the current version, UCP 600, in 2007. The ICC do not require banks or countries to indicate adherence to any set of rules as all ICC rules, including UCP 600, are based on the principle that they will apply if the credit is stated to be subject to them.

The content of the UCP 600 comprises:

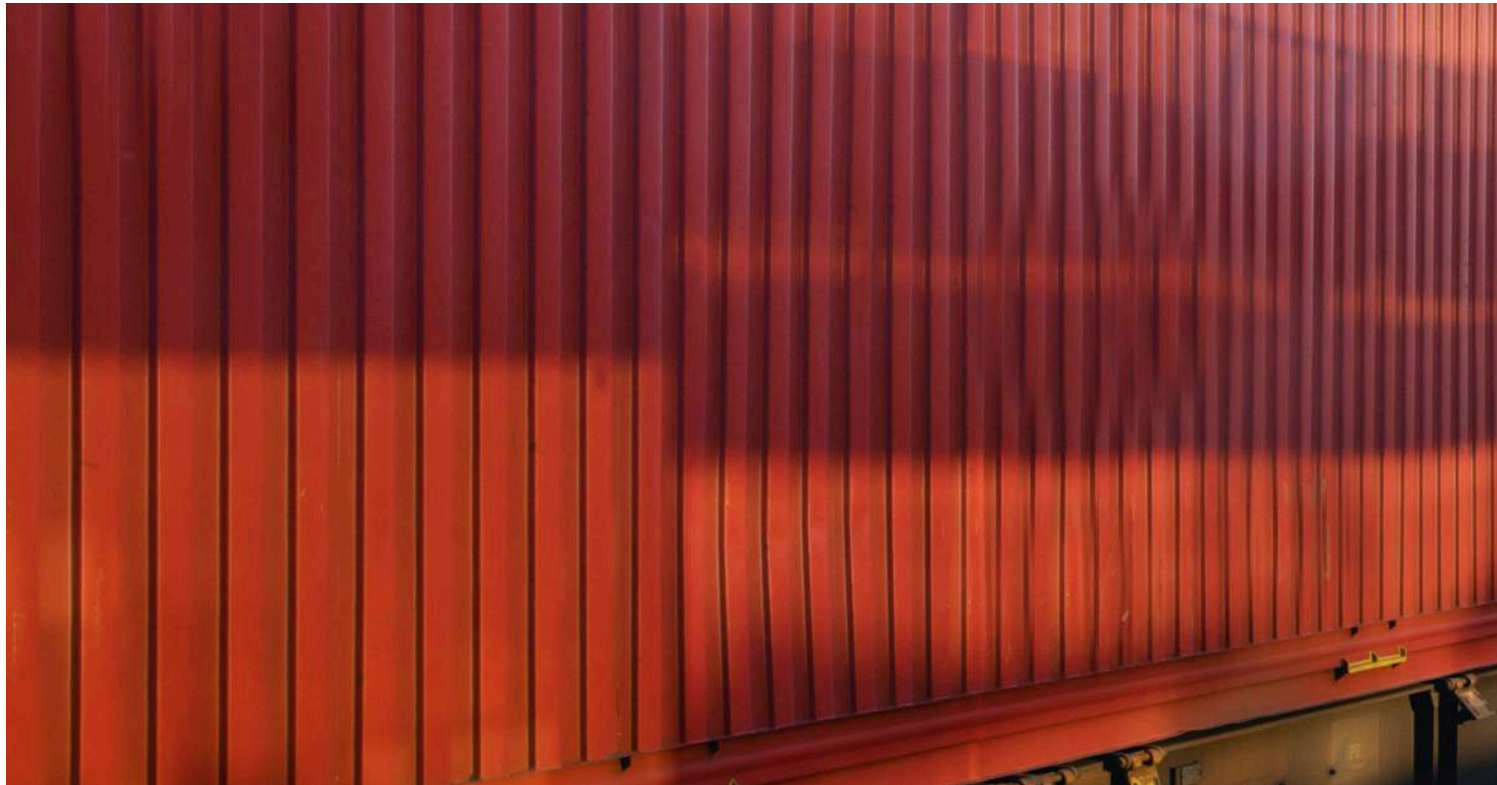
- Framework
- Structure of and obligations under documentary credits
- Pre-advice, nomination, reimbursement, standard for examination of documents, discrepant documents, waiver and notice, originals, and Invoice
- Transport documents
- Insurance documents
- Extension, tolerance, partial drawing or shipment, instalments, disclaimers, and force majeure
- Transferable credits and assignment of proceeds

The UCP 600 does not indicate which documents or under what circumstances parties must present under a documentary credit. These decisions are left to the applicant and beneficiary to determine. However, an issuing bank may insist on certain documents being presented from a local regulatory perspective or due to its internal policy.

ISBP 821

The International Standard Banking Practice for the Examination of Documents under Documentary Credits (ISBP 821) reflects the existing practice. It has evolved into





ISBP 821

The International Standard Banking Practice for the Examination of Documents under Documentary Credits (ISBP 821) reflects the existing practice. It has evolved into a necessary companion to the UCP for determining compliance of documents with the terms of documentary credits.

It is important to note that the ISBP does not amend the UCP 600. Instead, it explains how documentary credit practitioners apply practices expressed in the UCP 600. The ISBP and the UCP should

be read in conjunction, not in isolation.

Incorporating the ISBP into the terms of a documentary credit is inappropriate, as the requirement to follow agreed practices is already implicit within UCP 600.

Applied correctly, the ISBP helps reduce the large percentage of documents refused for discrepancies on the first presentation to a bank.

The ISBP publication outlines standard practice globally and encompasses an intelligent checklist of procedures for document checkers to examine documents presented under

documentary credits. The intent is to explain how practices articulated in UCP 600 are applied by documentary credit practitioners, thus providing a framework under which a beneficiary may prepare its documents to a standard that can be accepted globally.

The content of the ISBP 821 comprises:

- Preliminary considerations
- General principles
- Drafts and calculation of maturity date
- Invoices



- Transport document covering at least two different modes of transport (multimodal or combined transport document)
- Bill of lading
- Non-negotiable sea waybill
- Charter party bill of lading
- Air transport document
- Road, rail, or inland waterway transport documents
- Insurance documents and coverage
- Certificate of origin
- Packing list, note, or slip (packing list)
- Weight List, note, or slip (weight list)
- Beneficiary's certificate
- Analysis, inspection, health, phytosanitary, quantity, quality, and other certificates (certificate)

UCP 600

Under most documentary credits, the corporate parties involved are domiciled in different countries. For this reason, documentary credits subject to the UCP 600 do not

state which particular jurisdiction would apply in the event of any issues or disputes.

However, considering that most documentary credits are issued subject to the UCP 600, a uniform approach is already in place. This dramatically reduces any variances caused by divergent national laws.

6

Financial crime, fraud, and sanctions

Financial crime

By making available to their clients an array of trade finance products designed to facilitate international trade, banks have become accustomed to the need for practical tools and processes that manage and mitigate operational and documentary risk. Fraud and, to varying degrees, sanction regulations have also required close monitoring with the inherent creation of specific practices, processes, and technological aids.

Recently, financial crime has taken centre stage to the extent of an increased and collaborative focus on combating the issue. It can significantly negatively impact individuals, companies, and the economy of countries.

Fraud is, and always will be, a potential risk in trade finance transactions. However, while it is crucial to identify fraudulent transactions, they impact only a tiny percentage of global trade finance volumes.

The ICC Financial Crime Risk and Policy Group describes financial crime as laundering money, financing terrorism and providing weapons for prohibited uses, breaking sanctions, financial fraud, financial crimes such as tax evasion, and other predicative offences related to trade products and other financial services.



Many international bodies have been established to combat such crime, with part of their focus on providing tools to help prevent and identify suspect transactions. On an organisational level, there are several things that firms can do to help mitigate their exposure to financial crime and the resulting implications.

All companies should maintain internal guidelines advising staff on the compliance requirements for handling trade finance transactions. A key element should be identifying and handling transactions covering dual-use goods, which are goods that can be used for both civil and military purposes.

Operations departments are not generally required to investigate commercial transactions that fall outside their scope of business or the type of transaction being handled. However, they should be aware of the business of their counterparties and usual trading patterns.

An organisation can occasionally find itself in a situation with potential legal implications and costs and the risk of irreparable damage to its reputation. *Reputational risk can often have far more significant consequences than the imposition of any financial penalty.*

Fraud

Fraudulent trade transactions have occurred since trading began thousands of years ago. Buyers and sellers must know the potential for fraud and have safeguards built into their processes and procedures. There is a saying that all stakeholders should consider: "If it sounds too good to be true, it usually is."

Lord Diplock (1907–1985), an English judge, referred to fraud in a documentary credit transaction as: "Documents that contain, expressly or by implication, material representations of fact that to [the issuer's] knowledge are untrue."

As with financial crime, companies must adopt processes, procedures and guidelines for identifying, escalating, and reporting fraudulent transactions to minimise potential financial loss.

Fortunately, fraud only impacts a tiny fraction of trade finance transactions due to the safeguards and risk mitigants inherent in ICC rules, provided they are used and complied with.

Here are some examples of common fraud-related scenarios:

- A buyer believes that the seller has committed fraud and seeks to prevent a bank from effecting payment by obtaining a court injunction.
- Fraud based on either non-existent or poor-quality goods or falsifying one or more documents within a presentation under a documentary credit, standby credit, or guarantee.
- A bank refuses to pay the beneficiary based on alleged or proven fraud.
- A bank has effected payment, and a refund of the payment is required due to fraud.
- Fraudulently issued bank undertakings such as documentary credits, standby credits, and guarantees.





Sanctions

A sanction is a measure adopted against a country, regime, or individual that officials believe is violating international law. Sanctions are also political trade restrictions to maintain or restore international peace and security.

Sanctions concerning trade finance are financial or trade controls that can be (and are) imposed for political or economic reasons by the United Nations, the Office of Foreign Assets Control (OFAC) in the USA, the European Union (EU) Council, and individual countries.

The main objective of a sanction varies according to the applicable circumstances.

For example, an arms embargo and a ban on the export of certain items or raw materials could be aimed at supporting a peace process and restricting the financing of weapons by combatants. Sanctions are also commonly aimed at preventing weapons from falling into the wrong hands.

Several other examples of objectives that sanctions may seek to achieve are:

- A change in the conduct of a particular country, regime, company, or individual.
- Placing pressure on a country, regime, company, or individual to comply with set objectives.
- As a punitive measure when peace and security are threatened.

- Deterring, preventing, and suppressing terrorist financing and terrorist acts.

Failure to comply with sanction regulations can be extremely costly, not only in terms of a monetary fine but also damage the reputation of the concerned parties.

ICC Banking Commission

The ICC Banking Commission issued a guidance paper on using sanctions clauses in documentary credits in 2010, updated in 2014. The paper deals with the use of clauses concerning trade, economic or financial sanctions, or embargoes in trade finance instruments (documentary and standby letters of credit,



demand guarantees, and counter-guarantees) that are subject to the rules drafted by the ICC Banking Commission.

The issue of sanctions applying to documentary credit transactions has surfaced several times. As stated in the paper, sanction clauses have become problematic because they lead to uncertainty about their application and could defeat the independent nature of such instruments. The purpose of the ICC's guidance paper was to highlight this issue and recommend best practices in that respect.

Owing to a resurgence in using sanctions clauses in documentary credits, the ICC addressed this issue again and released an addendum to the guidance paper in May 2020.

The key messages in this addendum are that:

- 1** Sanctions clauses should not be used routinely.
- 2** Any clause should be drafted in clear terms according to the sample clause.

The ICC re-states the recommendation that sanctions clauses should not be used under normal circumstances. However, if one is to be used, then such a clause should be drafted in



clear terms, restrictively, to limit the reference only to mandatory law applicable to the bank, according to the following sample clause:
"[notwithstanding anything to the contrary in the applicable ICC Rules or in this undertaking,] we disclaim

liability for delay, non-return of documents, non-payment, or other action or inaction compelled by restrictive measures, counter-measures or sanctions laws or regulations mandatorily applicable to us or to [our correspondent banks in] the relevant transaction."

7

Ensuring credit-compliant presentations of documents

Trade documents have existed since the dawn of the written word, and archaeologists have recovered 'documents' in the form of clay tablets that date back many thousands of years. Without documents, there is no documentary credit, meaning that a seller does not get paid, and a buyer does not get its goods.

All parties involved in the trade cycle need documentation, albeit with differing requirements, and each type of document serves a different purpose.

There are many document types, and it is essential to understand the intent of the documents required under a documentary credit. Most countries have a minimum requirement for import and export documentation, and many have numerous specific and unique requirements. Still, practitioners should be aware of and account for these in the terms and conditions of the documentary credit.

Poorly prepared documents can severely impact a transaction, leading (at best) to delays in settlement. Global statistics differ, but the percentage of documents refused by banks on the first presentation ranges between 65% and 80%.

Discrepancies

While some of the more common discrepancies are due to timing issues (expiry, shipment, and presentation period), quite a few derive from poorly prepared documents or presentations. These can include conflicting data between documents, missing documents, unauthenticated alterations, missing endorsements, goods descriptions not according to the documentary credit, insurance documents dated later than the transport document, and missing or incorrect shipped-on-board notations.

As a result of discrepancies in a presentation, practitioners incur additional costs by way of discrepancy fees (from the nominated bank or issuing bank), expenses for communications sent, lost interest, and increased administrative costs. These will all lead to a reduced profit margin on the transaction. Discrepancy fees, for example, can be expensive and often range from the equivalent of USD 25 to USD 500 per presentation.

Refusals can lead to banks making no payment in some transactions. This can be due to a confirming bank or issuing bank refusing to honour or negotiate owing to the



perceived financial risk of the issuing bank or applicant.

Although an applicant may agree to issue a waiver for any discrepancies found in a presentation, the issuing bank is not obligated to accept it. The issuing bank may continue to refuse to honour the presentation and will be entitled to subsequently return the documents.

Some applicants will use discrepancies in a presentation to 'negotiate' a discount with the respective beneficiary in return for the applicant agreeing to issue its waiver.

Preparation of documents

A beneficiary may issue any document except where:

- a) the rules state otherwise,
- b) the documentary credit specifies the name of the issuer, or
- c) the documentary credit refers to the type of issuer as an independent, competent, qualified, or local company. UCP 600 interprets this as any issuer except the beneficiary.

Beneficiaries can avoid discrepancies in presentation by paying more attention to detail and reducing unnecessary data in the documents. This is achieved by carefully considering whether to include additional or redundant information on a document and avoiding anything that could call into doubt the compliance of a document. Only incorporating data required by the terms and conditions of the documentary credit or the ICC rules will significantly increase the likelihood of a presentation being found compliant.

If in any doubt as to the requirements for the completion of any document, always contact the nominated bank and seek their guidance. For documents not issued by the beneficiary, provide the

relevant freight forwarder, carrier (or its agent), or insurance company with a copy of the documentary credit to ensure they can comply with its instructions. This should happen before the shipment of the goods.

If there are any issues, seek an amendment from the applicant and refrain from relying on their stating that the amendment will follow or presenting documents on the basis that they will authorise settlement despite any discrepancy. If documents are discrepant, there is no undertaking from the issuing bank or any confirming bank.

ICC rules

Even before commencing the preparation process, a beneficiary should understand the rules. In particular, they should be aware of and understand the implications of the content of UCP 600. It is also recommended that beneficiaries have an understanding of ISBP 821.

The fact that this addresses the examination stage will provide the opportunity to understand the issues that bank document examiners will focus on.

ISBP 821 additionally makes it clear that the preparation of documents should start early in the chain. Before issuing the documentary credit, the

beneficiary and the applicant should carefully consider the documents required for presentation, by whom they are to be issued, their data content, and the timeframe in which they will be presented.

As an example of the content of ISBP, the publication includes references to misspellings and typing errors. These can cause all sorts of problems and, in a worst-case scenario, will lead to a refusal of documents. However, not all misspellings and typing errors make a document discrepant if they do not affect the meaning or intent of a word or sentence.

Creating a checklist that provides guidelines on the basic requirements for the more common documents is worthwhile to ensure compliance with the terms and conditions of a documentary credit. While an all-inclusive checklist covering every possible documentary requirement is not feasible, providing a generic one covering the typical documents under a documentary credit and the standard information within each document is possible.

Staff preparing documents should still thoroughly review them before their presentation under the documentary credit.

8

Handling document discrepancies

When firms present documents under a documentary credit, banks examine them against the terms and conditions of the documentary credit based on UCP 600 (provided the documentary credit is subject to it), international standard banking practice, and data between the documents themselves.

If the documents do not comply, they are discrepant.

In documentary credit operations, advising document discrepancies is the most contentious issue a bank will face with its clients or another bank. It is, therefore, imperative that the respective discrepancies are of such detail that the presenter is in no doubt about the reason for the refusal. A beneficiary should always seek clarification if a bank is unclear in its rejection of presented documents.

Whether or not a bank refuses documents is based on the content of the documents themselves and their conformity to the documentary credit and UCP. Ultimately, any discrepancy should stand one test: "Would you feel comfortable justifying that discrepancy before a judge in a court of law?" Remember, at the end of the day, a court will make the final judgement if the parties cannot amicably resolve a dispute.



Clarity is the key. A bank that provides a refusal notice stating "Invoice not as per LC" tells the beneficiary or the applicant nothing. Is the goods description wrong? Is a required certification missing? Is there some other specific issue? A refusal notice must be of sufficient detail and clarity for the presenter of the documents to understand it without having a copy of the actual documentary credit in front of them.

Pre-requisites

A covering schedule accompanying the documents should include the presenter's reference number and contact details in case of any problems.

It should also include information on how and where to make payment, reference to payment of charges, and details of where and how to send the settlement advice.



UCP 600 allows banks a maximum of five banking days following the presentation day to determine if a presentation is complying. It is important to note that, in most circumstances, documents will be examined by the nominated or confirming bank and the issuing bank. Each bank has a maximum of five banking days to examine the documents.

The UCP 600 does not expect banks to need the full five banking days to examine documents, although certain circumstances may exist when this is the case. Competition between banks for business typically ensures that most presentations are reviewed within 48 hours, if not on the day of receipt.

Obligations of a bank

A nominated bank that has agreed to act on its nomination, a confirming bank, or an issuing bank must determine whether the documents are compliant. Each bank must decide whether or not to issue a refusal notice based on its examination of the documents. However, it does not always follow that a bank that identifies a discrepancy will refuse the documents.

The bank may not consider a discrepancy to warrant a refusal. One example of a minor difference would be if the documentary credit required six document copies, but a presenter only provided five. In this case, the bank may opt to make the additional copy itself rather than refuse the documents.

In respect of an issuing bank, it must decide whether or not to approach the applicant for a waiver of discrepancies.

Approaching the applicant for a waiver can give rise to five different results:

- 1** The applicant agrees to waive, and the issuing bank accepts the waiver. Issuing bank honours.
- 2** The applicant agrees to waive, but the issuing bank does not agree to accept the waiver. The issuing bank issues a refusal notice indicating it is returning the documents or seeking further instructions for their disposal or handling.
- 3** The applicant does not agree to waive, and the issuing bank issues a refusal notice indicating it is returning the documents or seeking further instructions for their disposal or handling.
- 4** The applicant has not provided its waiver of discrepancies within the time allowed by the UCP 600 (which can be no later than the close of the 5th banking day following the day of presentation unless the credit says otherwise), so the issuing bank refuses the documents.



- 5** The issuing bank withdraws the request for a waiver due to an incorrect refusal. (This would happen if the presenter provides a valid argument for withdrawing the discrepancy—for example, particular wording of the documentary credit or an amendment appearing within a document).

Issues for a beneficiary to consider

Through this process, there are several issues for the beneficiary to consider. For example, can it be sure that the documents are discrepant? Has the bank missed a condition in the documentary credit? Has data been inserted on a document but not seen?

Beneficiaries must be aware of the content of the UCP 600, particularly articles 3, 14, and 17–32, together with the practices outlined in the ISBP. The ISBP is a publication which, by title, refers to the examination of documents by banks and how they should apply the articles of UCP 600 to given documents.

Using reverse logic, if a beneficiary understands how a bank will examine its documents, it should be able to prepare them to that standard and avoid many problems.



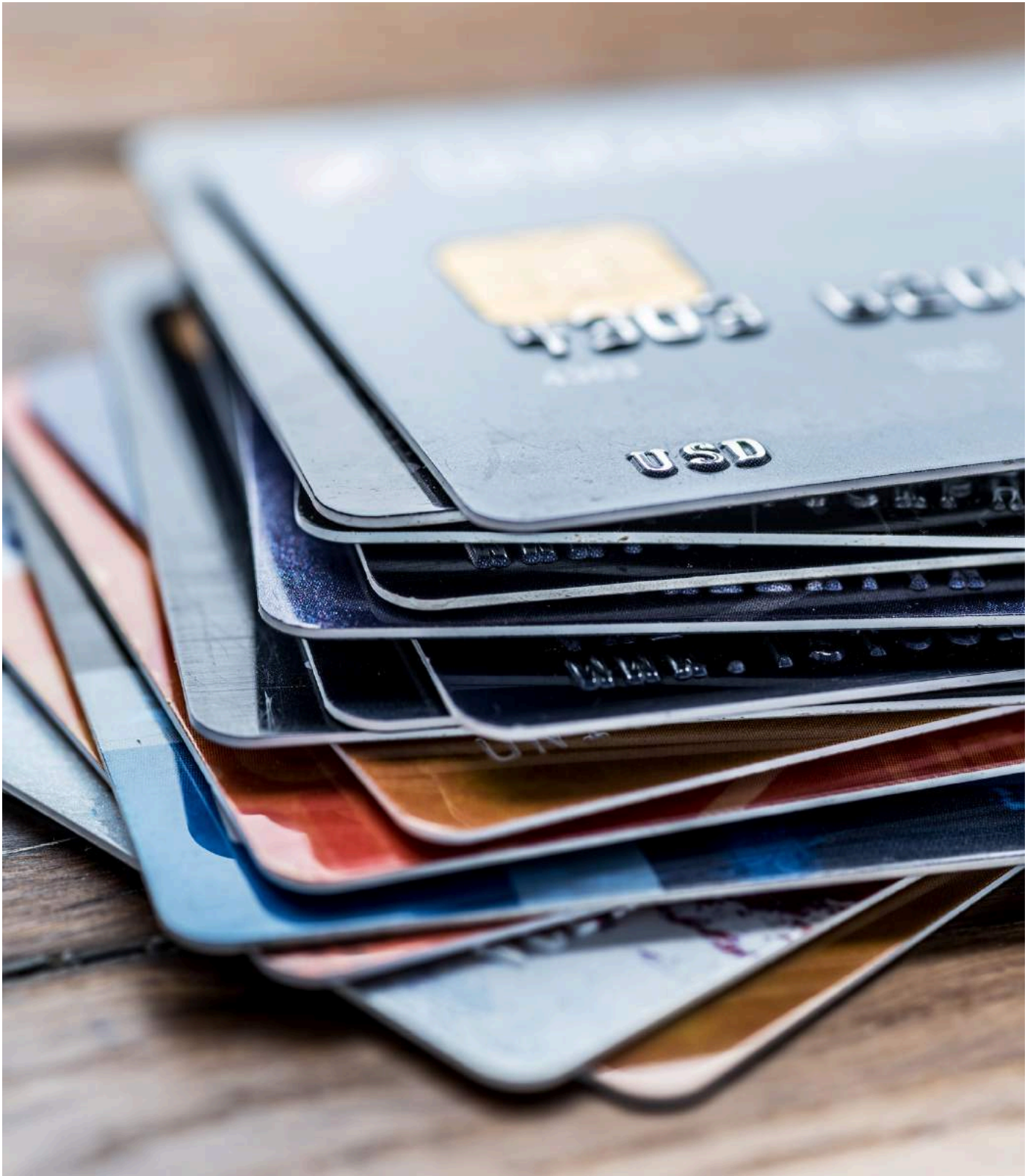
Options in the event of discrepancies

If there are discrepancies, three options exist:

- 1** Correct the discrepancies by either amending the documents or by replacement,
- 2** Request that the nominated bank or confirming bank sends a message to the issuing bank seeking approval to honour or negotiate despite the discrepancies that they have found whilst holding the documents with them or
- 3** Request that the nominated or confirming bank forward the documents to the issuing bank for settlement.

In respect of point 3, the use of terms such as “on a collection basis” and “in trust”, are acceptable between the beneficiary and the nominated bank, **BUT SHOULD NOT** be used in any communications to the issuing bank, as they imply that the rules for documentary collections are to be applied rather than the rules for documentary credits.

Remember that the respective parties could avoid or resolve many discrepancies through careful attention to detail in the documentary credit or amendment application. Handled correctly, preparing and examining documents is valuable to the beneficiary, the applicant, and the industry.



9

Dispute resolution

Examining documents under documentary credits will often result in a difference of opinion as to whether the documents comply and, if considered to be discrepant, which discrepancies are applicable. In most situations, the discrepancies are apparent and result in no disagreement between the concerned parties.

Furthermore, although disputes can arise between any involved parties, they can generally resolve such conflicts quickly, without referral to any arbitration or legal process. However, on occasion, they may involve a third party.

The choice of dispute resolution will depend on the issues in dispute. Moreover, it is not advisable to include a reference to a preferred form of dispute resolution in a documentary credit when:

- a) there may be no dispute, but the addition of such a clause will give a false impression regarding the issuing bank (i.e., that there is an anticipation of a dispute arising)
- b) the dispute may be inappropriate for the stated service (e.g., ICC DOCDEX, a named court or jurisdiction, or a named arbitration tribunal)

Options in the event of discrepancies

Confronted by numerous and often complex problems in establishing documentary compliance and interpreting rules and document content, parties involved in trade regularly approach the International Chamber of Commerce (ICC) for guidance. Since 1933, the ICC has made available seven UCP publications, two bank-to-bank reimbursements (URR) publications, five ISBP publications, and numerous guidance and briefing papers.

In addition, over the last few decades, the ICC Banking Commission has drafted and released hundreds of official opinions in response to questions posed by parties involved in trade activities. The ICC arbitration service, Documentary Dispute Resolution Expertise (DOCDEX), has also resolved many disputes.

Options in the event of discrepancies

In response to requests for clarification and interpretation for resolving disputes submitted by individuals, banks, corporates, logistics





companies, and law firms, the ICC Banking Commission created the “Official ICC Banking Commission Opinions”. This resource provides expert interpretation and analysis of its rules and transactions issued subject to such ICC rules, including the UCP 600, which are the subject matter of the bulk of ICC opinions.

Courts often cite ICC Banking Commission Opinions to assist in dispute resolution and are considered a significant resource for lawyers, bankers, judges, scholars and other professionals in the industry. The opinions are not binding. However, they have been used in evidence in court cases for many years to support the position of a defendant or plaintiff.

ICC DOCDEX

The purpose of DOCDEX is to provide parties with a specific dispute resolution procedure that leads to an independent, impartial, and prompt expert decision in settling disputes.

The ICC launched this service in 1997 as an alternative dispute resolution system for parties using ICC rules relating to letter of credit transactions. However, it has now expanded to cover all ICC rules.

The ICC International Centre for Expertise (Centre) monitors and handles the process.

Courts and arbitration

Unfortunately, there are occasions when neither an ICC opinion nor DOCDEX will solve the problem. In such circumstances, the involved parties may turn to the courts, which can be a costly and time-consuming option and will include a wide range of costs relevant to the legal process.

It is worth noting that over the years, many courts have used the content of existing ICC opinions and DOCDEX decisions as the basis for their deliberations and conclusions.

An arbitration or mediation service is far more likely to occur in disputes between a buyer and seller relating to a contract of sale than a dispute concerning the status of documents under a documentary credit and the UCP.

10

Digitalisation and the future

The UCP 600, while being invaluable in a paper world, is not to be intended to be applied to transactions involving electronic documents. Over time, traditional trade instruments will inevitably move towards a mixed ecosystem of paper and digital and, ultimately, to electronic records alone.

With this in mind, the ICC published the eUCP Version 1.0 in 2002 to address the presentation of electronic records under documentary credits. They issued an update in 2007 known as Version 1.1. To bring the rules in line with the changes in terminology in UCP 600, the ICC published Version 2.0 in 2019. Version 2.0 provides a complete update of the rules to ensure ongoing “e-compliance”.

The latest update, Version 2.1, published in July 2023, aligns the eUCP with the UNCITRAL Model Law on Electronic Transferable Records (MLETR) regarding issues of electronic transferable records. Furthermore, the rules align with the Electronic Trade Documents Act (ETDA) introduced in the UK in September 2023.

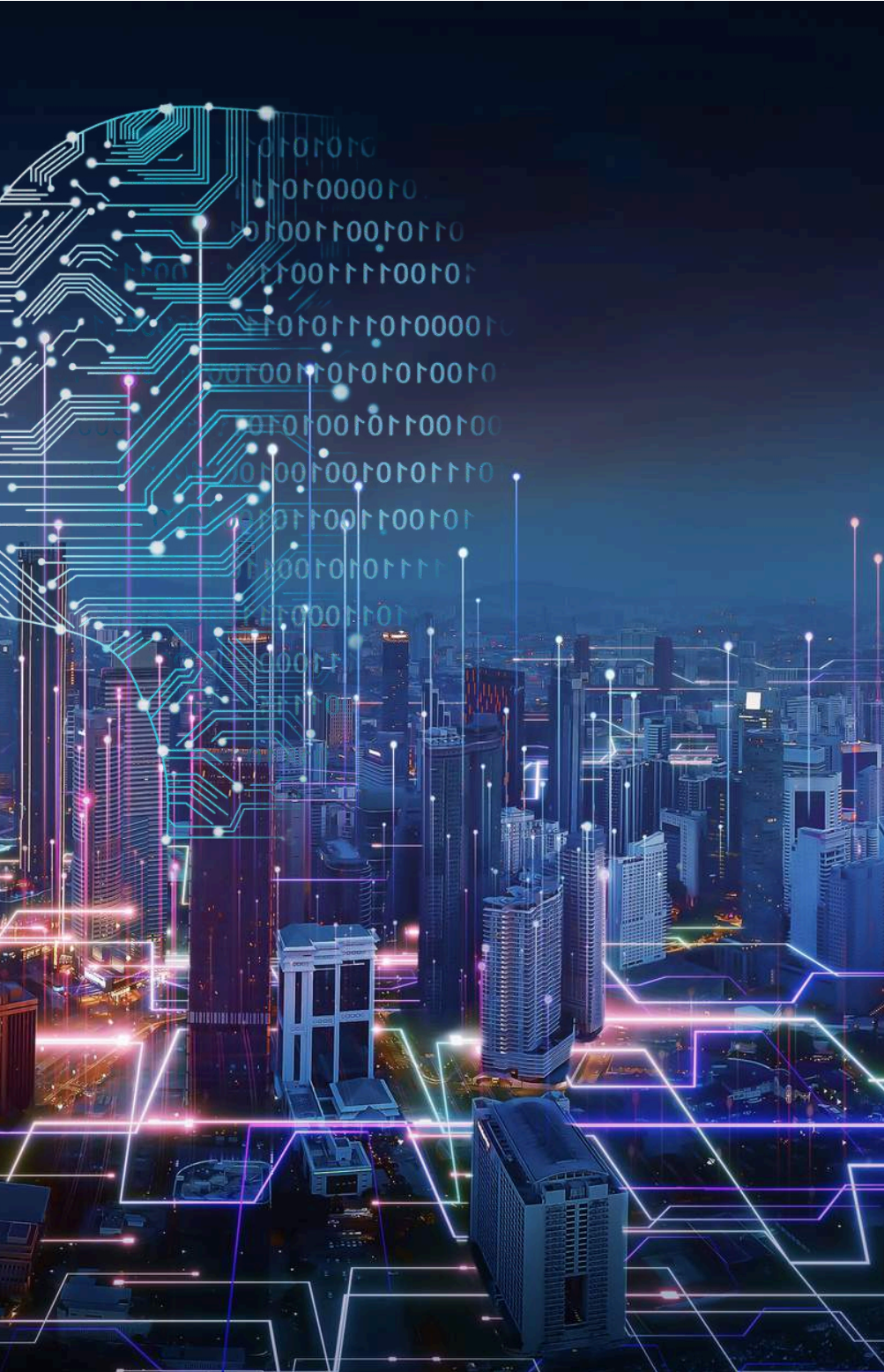
It was recognised at the outset that the likely end of the evolution to electronic presentations would be automated compliance checking systems in the documentary credit field.

This is all too apparent when looking at evolving technology and digital trade finance, with the advent of the Internet of Things (IoT), Distributed Ledger Technology (DLT), Smart Contracts, Artificial Intelligence (AI), Machine Learning, and Optical Character Recognition (OCR).

The ICC will continually monitor the content of the eUCP to ensure applicability, with these rules providing many benefits in advancing documentary credits in a digital environment and ensuring the continued relevance of this valuable instrument in mitigating trade risk. They have also produced several guides regarding the eUCP, including guidance for buyers and sellers in handling documentary credits subject to the rules.

The eUCP focuses on the presentation of electronic records, alone or in combination with paper documents, and not on the issuance of an eUCP credit. This decision was based on the fact that the industry has already issued electronic documentary credits for many years. In addition, there was concern that any rules surrounding issuance could encumber present and evolving electronic issuance practices while endangering the rules' technological neutrality. The rules are based on the underlying principles in the UCP





It is essential to consider the implications of the eUCP when issuing a documentary credit that will provide for the presentation of electronic records solely or in combination with traditional paper documents. Not doing so could negate many benefits.

For instance, as with credits solely subject to UCP 600, an applicant must ensure that any request for the issuance of an eUCP credit expressly clarifies and determines the appropriate documentary requirements as agreed with the beneficiary.

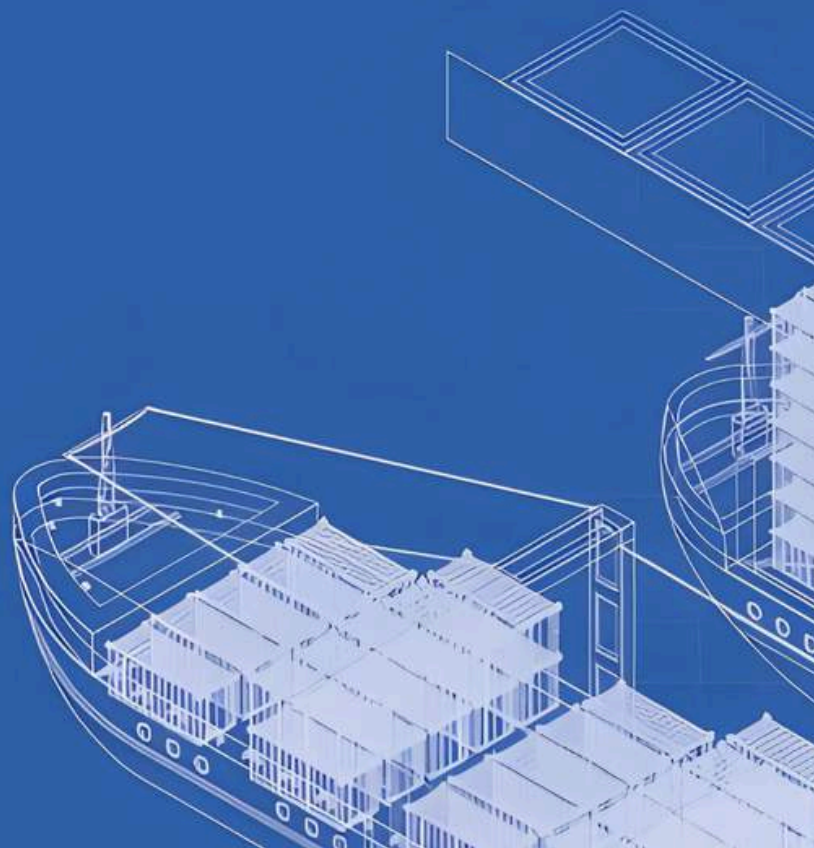
Concerning an eUCP credit, an applicant needs to make several additional considerations. The fundamental requirement, from which all else will evolve, is to jointly agree with the beneficiary of the credit that presentation of electronic records will be permitted and to determine which documents they can handle in this way.

During this dialogue, the beneficiary must provide reassurance that it can present any required electronic records and that such documents will be in an acceptable format. Before finalising the structure, they must also determine that it suits the issuing and nominated banks.

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BAFT, the leading global financial services association for international transaction banking, helps bridge solutions across financial institutions, service providers and the **regulatory** community that promote sound financial practices enabling **innovation**, efficiency, and commercial growth. BAFT engages on a wide range of topics affecting transaction banking, including **trade finance, payments, and compliance**.

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About the BAFT Letter of Credit Committee

The BAFT Letters of Credit working group is composed of members of the BAFT Commercial Letters of Credit Committee. The Committee focuses on issues and responds to questions that directly impact the processing environment related to commercial letters of credit. The committee provides comments on various ICC rules, practices, and queries related to commercial letters of credit operations.

The Commercial LC Committee also develops input, case study material, speakers, and oversight to the LC workshops as well as applicable participation in conference sessions on Trade. Additionally, the committee supervises and supports the ongoing work of the regional sub-committees: West Coast Letters of Credit, Southeast Letters of Credit, and Central Letters of Credit.

To learn more about the BAFT Trade Committees, visit www.baft.org/committees





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