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RISK ANALYSIS IN DOCUMENTARY LETTER OF CREDIT OPERATION

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Abstract

Documentary Letters of Credit are among most popular methods of payment used in international trade. They function as an irrevocable promise of issuing a bank to pay instead of an applicant buyer to a beneficiary seller under the condition that the beneficiary presents complying documents with terms and conditions of the credit to the bank. One of the reasons for the popularity of the LCs in international trade is shifting the payment risk from an individual buyer to a bank with a much stronger financial standing. However, LC operation in international trade is not free of risk. Despite the fact that two main principles of the Documentary Letter of Credit's Operation (Principle of independence and principle of strict compliance) facilitate the process of international trade significantly, but still all parties involved in LC operation are supposed to be cautious about the existing risks relevant to their role in LC operation. Current paper tries to use legal principles of docu-

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mentary credits and risk management theory in order to define existing risks to each party (beneficiary, applicant and bank) in international LC transaction and find an answer to the question of what are exposing risks for involved parties? For this purpose, the paper starts with an explanation of the two main principles of LC operation and moves forward with using the risk management theory to explain existing risks for each party in detail.

Keywords:

International Trade, Documentary Letter of Credits, Risk Analysis, Applicant, Beneficiary, Bank

1. Introduction

Documentary Letters of Credit have long history in international trade. However, their legal nature goes back to the eighteenth century¹. In the course of international trade, when two businessmen from different parts of the world decide to have a transaction with each other, in addition to other methods of payment, LC can help them a lot in the realization of their deal by guaranteeing the payment to the seller by a bank, whereas the buyer also receives a guarantee that according to the presented documents by the beneficiary to the bank, he will receive purchased goods in accordance with the conditions stipulated in the underlying contract of sales. Such operation is regulated in the Uniform Customs and Practices for Documentary Letters of Credits (currently UCP 600) which is a set of norms defined for regulation of international LC transaction introduced by the International Chamber of Commerce for the purpose of protecting the flow of international trade and safeguarding the operation of Documentary Letters of Credits. It is subjected to two main principles of Strict Compliance and Autonomy. However, LC transaction is not a risk free operation and the current paper will try to use risk management theory to find an answer to the question of what are the main attributed risks to each party in LC operation. Preventing associated risks to each party in LC transaction can save huge amounts of money for each party and save the reputation of Documentary Letters of Credit as an effective and safe method of payment in international trade.

¹ J. Raymond, A. Malek, D. Quest, *Documentary Credits - The Law and Practice of Documentary Letters of Credits including standby credits and demand guarantees*, Haywards Heath 2009, p. 250.

2. The Principle of Strict Compliance

The principle of Strict Compliance express that issuing a bank's undertaking to honour the credit is effective only upon presentation of complying documents by the beneficiary which are stipulated in the credit². On the other hand, "the idea of strict compliance has developed from the general principle of the law of agency that an agent is only entitled to reimbursement from his principal if he acts in accordance with his instructions"³. Therefore, banks who act as an agent for applicant in documentary credits will receive reimbursement in case of honouring the credit against complying documents. The standard for examination of documents has been set in Article 14 of UCP 600:

"Article 14 Standard for Examination of Documents

a. A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying Presentation.

d. Data in a document, when read in context with the credit, the document itself and international standard banking practice, need not be identical to, but must not conflict with, data in that document, any other stipulated document or the credit".

The majority of discrepancies in practice of Documentary Letters of Credit include inconsistent data⁴, discrepant documents of transport⁵, mistakes in draft⁶, drafts without signature and inconsistent invoice with credit⁷, inadequate insurance⁸, and documents with wrong signature⁹.

In reality, principle of Strict Compliance is protecting interests of applicant under documentary credits process which requires shipment of promised goods by beneficiary before actualization of payment. There is an ongoing scholarly debate

² Inter alia Article 2; Article 7(a), Article 8(a)(c) and Article 15; Article 14 and Article 34 of UCP 600.

³ R. King, *Gutteridge and Megrah's law of bankers' commercial credits*, London 2001, p. 14.

⁴ Article 14(d) UCP 600.

⁵ Article 19 UCP 600.

⁶ Article 18(c) UCP 600.

⁷ Article 28 UCP 600.

⁸ B. Baker, *Exporting Against Letters of Credit*, <http://www.financepractitioner.com/operations-management-best-practice/exporting-against-letters-of-credit?full> (last visited 08.03.2017).

⁹ Article 34 UCP 600.

about what constitutes the complying presentation which can be traced into legal cases¹⁰. However, the most important question can be what is the characteristic of non-complying presentation?¹¹

There are two main theories regarding the determination of documentary compliance: Doctrine of Strict Compliance and Doctrine of Substantial Compliance¹².

2.1. Doctrine of Strict Compliance

According to the doctrine of Strict Compliance, presented documents should strictly comply with credit¹³. While former version of UCP (500) was requiring a bank to take a "Reasonable Care" in the process of examining compliance of presented documents by the beneficiary, UCP 600 has deleted such term which shows that only strict compliance is the criteria for reimbursement of a bank by the applicant. However, word by word compliance is not required by UCP 600¹⁴. Simple mistakes and typographic errors might not be considered as non-conformity during the examination of documents and banks are unlikely to reject documents with minor defects. According to Woods, UCP 600 does not use the term of Strict and also provides permission for insignificant inconsistencies or errors¹⁵. However, it is difficult to distinguish the insignificant error from the significant one. For example in *Seaconsar Far East Ltd v. Bank Markazi Jomhuri Islami Iran*¹⁶, the credit defining all documents should bear the credit number and buyer's name. However, one of the tendered documents missed the buyer's name and the credit number. The Lloyd LJ held that the bank was entitled to reject the presentation¹⁷:

¹⁰ H. M. S. Botosh, *Striking the Balance between the Consideration of Certainty and Fairness in the Law Governing Letters of Credit*, <http://etheses.whiterose.ac.uk/3063/> (last visited 09.03.2017), pp. 183-271.

¹¹ D. Krazovska, *Impact of the Doctrine of Strict Compliance on a Letter of Credit Transaction*, http://pure.au.dk/portal-asb-student/files/2543/Krazovska_MasterThesis.pdf (last visited 09.03.2017), pp. 25-43.

¹² Ibid.

¹³ Ibid.

¹⁴ B. Kozolchik, *Commercial Letter of Credit in the Americas: A Comparative Study of Contemporary Commercial Transactions*, Albany 1980. p. 10.

¹⁵ J. S. Wood, *Drafting letters of credit: basic issues under Article 5 of the uniform commercial code, UCP 600, and ISP98*, Banking LJ 2008, No. 125, p. 103.

¹⁶ *Seaconsar Far East Ltd V. Bank Markazi Jomhjouri Isami Iran* [1993] 3 W.L.R. 756 (HL), Lloyd's Rep. 1993, Vol. 1, No. 236.

¹⁷ C. M. Schmitthoff, *Discrepancy of Documents in Letter of Credit Transactions*, Journal of Business Law 1987, No. 95.

„[The plaintiffs] argues that the absence of the letter of credit number and the buyer's name was an entirely trivial feature of the document. I do not agree. I cannot regard as trivial something which, whatever may be the reason, the credit specifically requires. It would not help, I think, to attempt to define the sort of discrepancy which can properly be regarded as trivial.”

Therefore, discrepancies can be further divided into two main groups: *Irrelevant Irregularities* with no effect on principle of strict compliance and *Material or Genuine discrepancies* which violate the principle of strict compliance and result in rejection of documents by a bank¹⁸.

2.1.1. Irrelevant Irregularities

Except for the case of Commercial Invoice, UCP 600 does not require for strict compliance of any documents presented by a beneficiary with terms and conditions of the Credit. In fact, some articles provide tolerance up to 10 percent regarding the amount or quantity of credit while terms like ‘about’ or ‘approximate’ are used in the credit¹⁹. Other articles provide tolerance of 5 percent when quantity is not defined in the credit²⁰.

2.1.2. Material Discrepancy

There are numerous cases on material discrepancies. In *JH Raynor & Co. Ltd v. Hambro's Bank Ltd*²¹, the shipped goods were described in the bill of lading as „machine-shelled ground kernels”, however, the credit had the description of goods as „Coromandel groundnuts”. In the judgement of the court of appeal, it was held that the bank was correct about rejection of tender despite the fact that the terms were proved to be the same. As bank is not required to have the knowledge of the meaning of terms in different fields of trade²².

Other example is *Courtaulds North America, Inc. v. North Carolina Nat. Bank*²³ in which the credit stipulated an invoice for ‘100% Acrylic Yarn’ while the presented invoice described goods as ‘Imported Acrylic Yarn’. The bank rejected the presenta-

¹⁸ H. Alavi, *Documentary Letters of Credit, Principle of Strict Compliance and Risk of Documentary Discrepancy*. *Kor. UL Rev.* 2016 19, 3.

¹⁹ UCP600, Article 30 (a)

²⁰ UCP 600, Article 30 (b)

²¹ *JH Raynor & Co. Ltd v. Hambro's Bank Ltd* [\9Q3] Q.B. 711.

²² *Ibid.*

²³ *Courtaulds North America, Inc. v. North Carolina Nat. Bank* 528 F.2d 802, C.A.N.C [1975]803.

tion²⁴. The court held that the bank was entitled to dishonour the presentation despite the fact that the description of goods on packing list were matching with the credit on the basis that UCP has differentiated the invoice from remaining documents²⁵.

“Free of ineptness in wording the letter of credit dictated that each invoice express on its face that it covered 100% acrylic yarn. Nothing less is shown to be tolerated in the trade. No substitution and no equivalent, through interpretation or logic, will serve”²⁶.

*Bank Melli Iran v. Barclays Bank (Dominion, Colonial & Overseas)*²⁷ is another important case on material discrepancies. In the above mentioned case the payment was due upon presentation of commercial invoice for shipment of ‘100 new Chevrolet trucks’, while the invoice described goods as ‘in new condition’. The court held that the bank was entitled to reject the presentation as ‘in the new condition’ and ‘new’ are not the same²⁸.

2.1.3. Substantial Compliance

It is the test accepted by few courts in order to balance the interests²⁹. The requirement of test is that the banker should “look beyond the face of the documents, investigate the realities of the transaction, and weigh the credibility of documents, customers and beneficiaries”.³⁰ Substantial Compliance has been considered in contradiction with Article 5 of UCP 600 which emphasizes on limitation of bank’s responsibility to deal with documents not goods or services³¹.

²⁴ Ibid. p.806.

²⁵ Ibid.

²⁶ Ibid.

²⁷ *Bank Melli Iran v Barclays Bank (Dominion, Colonial & Overseas)* Lloyd’s Law Reports 1951, Vol. 2. No. 367.

²⁸ Ibid.

²⁹ C. Hotchkiss, *Strict Compliance in Letter-of-Credit Law: How Uniform is the Uniform Commercial Code?*, Uniform Commercial Code Law Journal 1991, No. 23, p. 295.

³⁰ Ibid.

³¹ UCP 600, Article 5

3. Principle of Autonomy

The second fundamental principle in operation of letters of credit is the Principle of Autonomy. This principle has been appreciated by national and international legal frameworks³². The principle of autonomy of letters of credit has been considered as “cornerstone of the commercial validity of the letters of credit”³³, and “the engine behind the letter of credit”³⁴. The autonomy principle of letters of credit has been clearly mentioned in article 4 of UCP 600:

“Article 4 Credits v. Contracts

a. A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary. A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank.

b. An issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract, proforma invoice and the like.”

Based on the Autonomy Principle and the text of article 4 of UCP 600, the beneficiary exporter has assurance that his payment will be due upon presentation of complying documents to the issuing bank while neither bank nor the account party can deny payment based on the arguments related to the performance of the underlying contract. Therefore, even in cases of argument on the performance of the underlying contract account party and the issuing bank have no other choice rather than paying the beneficiary upon presentation of complying documents and seek remedy by suing him for the breach of underlying contract. As a result, the Autonomy Principle has been considered a means of promoting international trade by following the logic of “pay first, argue later”.³⁵

³² Article 4 UCP 600; Article 2(b) URDG; Articles 2 and 3 UNCITRAL-Convention; sections 5-10 (1)(a), 5-114 (1) and 5 5-103(d) UCC

³³ *Ward Petroleum Corp. v Federal Deposit Ins. Corp.* (1990) 903 F.2d 1299

³⁴ J. Dolan, *The Law of Letters of Credits*, Boston 2002 [12.03]480

³⁵ *Eakin v Continental Illinois National Bank & Trust Co.* (1989) 875 F.2d 114 .116.

The autonomy principle also has been considered as the foundation for smooth operation of letter of credits by many scholars:

„We should also remember that in many international trade transactions, there are more parties involved than just the buyer or seller. The seller usually had to obtain goods or raw materials from a supplier before he is able to meet the contract made with the buyer. The seller will need to be financed in making payment to their suppliers. That financing comes from the negotiation or discounting of drafts drawn under the documentary credit system. Such system of financing would break down completely if the dispute between the seller and the buyer was to have the effect of „freezing” the sum in respect of which the letter of credit was opened”³⁶.

In order to completely address the essence of the autonomy principle, article 5 of UCP 600 specifies: “banks deal with documents and not with goods, services or performance to which the documents may relate”³⁷.

3.1. Main functions of the Autonomy Principle

The main functions of the autonomy principle in operation process of Documentary Letters of Credits have been defined as:

3.1.1. Payment Function:

By separating the underlying contract from the credit and substituting risks of each party, the autonomy principle reduces the commercial risk of trade³⁸. As a consequence, the beneficiary receives the payment after the tender of complying documents and the bank received reimbursement from the account party regardless of existence of any relevant dispute to underlying contract³⁹.

3.1.2. Commercial Function

The commercial function of the Principle of Autonomy has been discussed by Professor McCormack⁴⁰ as an assurance for reimbursement of the issuer based

³⁶ J. Chuah, *Law of International Trade*, 4th ed, London 2009, p. 436.

³⁷ UCP 600, Article 5.

³⁸ G. McCormack, *Subrogation and Bankers Autonomous Undertakings*, Law Quarterly Review 2000, No. 45.

³⁹ R. P. Buckley, X. Gao, *The Development of the Fraud Rule in Letter of Credit Law: The Journey so Far and the Road Ahead*, University of Pennsylvania Journal of Economic Law 2002, Vol. 23, No. 663.

⁴⁰ P. A. Alces, *An Essay on Independence, Interdependence and the Suretyship Principle*, University of Illinois Law Review 1993, No. 480.

only on the complying tender document by the beneficiary while requiring it to undertake the ministerial function of document checking⁴¹ and fund transfer⁴² in order to remove any doubts about its payment undertaking⁴³. On this basis, the British cases bind the bank to pay even on the occasion of tendering forged⁴⁴ and incorrect documents⁴⁵ and regardless of the facts represented by the documents⁴⁶.

3.1.3. Financing Function:

The financing function has two main characteristics. Firstly, it protects the beneficiary and the applicant from any interference from being reimbursed by the issuing bank after paying the beneficiary⁴⁷. Secondly, it provides a support of leveraging other transactions for the beneficiary by the credit which has been issued in his favour⁴⁸.

Finally, comments of Hirst J in *Tukan Timber Ltd v. Barclays Bank Plc*⁴⁹ clearly illustrates bank's obligations under documentary credits.

"It is of course very clearly established by the authorities that a letter of credit is autonomous. That the bank is not concerned in any way with the merits of the underlying transaction, and only in the most extremely exceptional circumstances should the Court interfere with the payment bank honouring a letter of credit in accordance with its terms bearing in mind the importance of the free and unrestricted flow of normal commercial dealings"⁵⁰.

⁴¹ C. Hare, *Not so Black and White: The Limits of the Autonomy Principle*, The Cambridge Law Journal 2008, No. 288.

⁴² G. McCormack, *Subrogation...*

⁴³ C. Hare, *Not so Black and White...*

⁴⁴ *Gian Sing & Co.Ltd v. Banque de l'Indochine* 2 All E.R. 754 (1974).

⁴⁵ *Pacific Composites Ply Ltd & Anor v. Transpac Container System Ltd & Ors.*

⁴⁶ L. J. Staughton, *IE Contractors Limited v. Lloyds Bank Plc.*, Lloyds Rep 1990, Vol. 2. No. 496, p. 499.

⁴⁷ M. Yifrach, *Third Party's Attachment on Letter of Credit Proceeds*, Journal of Business Law 2001, No. 159; R. S. Rendell, *Fraud and Injunctive Relief*, Brooklyn Law Review 1990-1991, No. 113.

⁴⁸ R. L. F. Garcia, *Autonomy principle of the letter of credit*, Mexican Law Review 2009, Vol. 3, No. 1, p. 77.

⁴⁹ *Tukan Timber Ltd v. Barclays Bank Pic.* Lloyd's Rep. 1987, Vol. 1, No. 171.

⁵⁰ *Ibid.*

4. Risk Analysis

In the operation of Documentary Letters of Credits at least three parties will be involved. However, in accordance with complexity of the transaction, the number of parties and contracts among them will increase in practice. Main parties to LC transaction are the applicant, the beneficiary and the issuing bank but, advising bank, confirming bank, negotiation bank and reimbursing bank can be added to this list. Similar to all methods of payment in international trade each party in LC transaction is exposed to some level of uncertainty. The rest of the current paper will be dedicated to different types of the risk which can face either party in LC transaction.

4.1. Risks of the Applicant

4.1.1. Fraud Risk

The principal of independence in Documentary Letter of Credit operation facilitates the process of international trade by relying on the conformity of documents presented to the bank in order to honour the credit. However, it can also raise the risk of fraud by providing ill-fated beneficiary the opportunity to present forged documents which are confirming with the terms of credit on their face without fulfilling his obligations in the underlying contract of sales⁵¹. UNCITRAL report provides a list of four most common types of fraud which an applicant can face as a result of sole reliance of banks on strict compliance of documents presented by the beneficiary:⁵² The first one is falsification of documents by the beneficiary in order to obtain the payment from the issuing bank when no cargo exists in practice. The second is when delivered goods by the beneficiary do not comply with the contract of sales in quantity and quality. The third is selling the same cargo to more than one person and the fourth is issuing the document of title (bill of lading) twice for the same cargo. Additionally, banks have also been reported as frequent victims of fraud in LC transaction⁵³. *Sztejn v Henry Schroder Bank-*

⁵¹ H. Alavi, *Mitigating the Risk of Fraud in Documentary Letters of Credit*, Baltic Journal of European Studies 2016, Vol. 6, No. 1, pp 139-156.

⁵² UNCTAD, *A Primer on New Techniques Used by the Sophisticated Financial Fraudsters with Special Reference to Commodity Market Instruments* (UNCTAD/ DITC/COM/39), 7 March 2003, available at unctad.org/en/Docs/ditcom39_en.pdf, (visited 10 January 2017).

⁵³ H. Alavi, *Autonomy Principle and Fraud Exception in Documentary Letters of Credit, a Comparative Study between United States and England*, International and Comparative Law Review 2015, Vol. 15, No. 2, p. 45.

*ing Corporation*⁵⁴ is the legal case of LC transaction in which fraud was applied for the first time as the exception to the independence principle in LC operation. Despite the fact that the fraud rule is recolonized in different jurisdictions, still many courts prefer not to interfere in the autonomy of Documentary Letters of Credit which makes the applicant vulnerable to the risk of fraud. Interestingly, UCP 600 has taken an absolute silent position regarding the risk of fraud while leaving it open to national legal systems.

4.1.2. Risk of Inferior Quality and Quantity

Another risk which an applicant bears would be receiving goods with inferior quality and quantity instead of complying with the ordered quality in the international sales contract. Due to the documentary nature of LC transaction, in most cases, the applicant can have access to the document of title of ordered goods only after the negotiation of credit and receiving payment by the beneficiary. Therefore, there is a possibility for the beneficiary to ship the goods with inferior quality or quantity and negotiate the credit before the applicant has the access to the goods.⁵⁵

4.1.3. Exchange Rate Fluctuation Risk

Regardless to the type of credit used in LC transaction, it will take some time for a ship to go from the port of departure to the port of destination. Therefore, the applicant is always facing with the fluctuation risk of exchange rate in highly volatile foreign currency market. In international trade the exchange fluctuation risk has direct relations with the length of payment period. This period is equal to shipping time in sight LCs, defined number of days after issuing LC in Usance LCs and defined number of days after receiving goods in port of destination in Deferred LCs. We should add the document examination time to the above mentioned time period⁵⁶. The exchange rate risk will be against the applicant when her local currency is depreciating against the currency of the credit.

⁵⁴ *Sztejn v Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941).

⁵⁵ K. Godier, *Trends Show a Declining Reliance on Letters of Credit*, *Documentary Credits Insight* 2001, Vol. 7, No. 3.

⁵⁶ Y. Hao, L. Xiao, *Risk Analysis of Letter of Credit*, *International Journal of Business and Social Sciences* 2013, Vol. 4, No. 9, p. 207.

4.1.4. Marketing Risk

There might be a substantial time lag between the effectuating payment in documentary letters of credit after negotiating complying documents and receiving the goods in the port of destination by the applicant. This can result in marketing risks in some unstable markets for the applicant.

In such occasion, the applicant faces with the risk of loss and marketing risk by decreasing the price of the imported goods in his home country during the shipping period.

4.1.5. Risk of Issuing Bank's Negligence

Despite its very low probability, it is possible that the issuing bank relies on checking mechanisms of confirming and negotiating banks and releases problematic documents to the applicant without conducting due examination. As a result, the applicant faces with the risk of not receiving the release order from the carrier after presenting the forged or mistaken documents. On one hand, the bank has already honored or negotiated the credit and there is almost no possibility to reconstitute the money from the beneficiary and on the other hand, the applicant is unable to obtain the release order from the carrier because of non-complying documents⁵⁷.

4.2. Beneficiary's Risks

4.2.1. Buyer's Negligence towards Underlying Contract While Opening the LC

Despite the fact that terms and conditions of a credit should be in accordance with underlying contract, the buyer might neglect agreed terms in the contract of sales while opening the Letter of Credit or try to add new clauses in the Credit and change the deal in his own favour. Most frequent situations are witnessed in case of price fluctuation and strict foreign currency control in destination markets that lead to late opening or not opening of the credit by the applicant. The applicant might also disregard the underlying contract of sales by inserting conditions in the Credit. For Example, the applicant changes the port of delivery, terms of delivery, type of insurance or includes other restrictive terms which are known as 'Flexible Clauses'⁵⁸.

⁵⁷ R. Cranston, *Principle of banking law*, Oxford, New York, Athens 1997, p. 15.

⁵⁸ Y. Hao, L. Xiao, *Risk Analysis...*

4.2.2. Imposing intentional restrictions

The intentionally imposed restrictions by the applicant in the Letter of Credit Credit are other risks which might create problems for the beneficiary in the preparation of complying documents. For example, the applicant can use the fundamental principles of Documentary Credit Operation to require documents difficult to receive, such as requiring the signature of a specified authority or specific type of signature on a document as well as asking the insurance policy under the delivery term of CFR and FOB.

Other types of restrictions might include asking for the certificate of quality, quantity and price issued by the specified government authority. While it is possible to obtain the certificate of quality and quantity from the defined state institute in any given countries, the price certificate is only applicable to goods under export control regimes⁵⁹. The applicant can also impose restrictions on typing mistakes, requiring conflictual documents or even providing mistaken name and address which can affect presented documents and result in their rejection by the bank.

4.2.3. Risk of Conflict between LC Clauses and Applicable Law of Sales Contract

The beneficiary should consider the conflict of laws among national law of his own country, the applicant's country and the applicable law to the underlying contract of sales while reviewing LC clauses. Such negligence can cost a lot for the beneficiary as there might be significant differences among applicable law to the contract of sales, beneficiary's national law and the terms of the Credit. Hao and Xio comment of the case of a Letter of Credit issued by one British Bank requiring 'all-risks' insurance policy from a London Association insurance Company and a 'war risk' insurance policy from a Chinese Insurance Company⁶⁰. According to the national law of the People's Republic of China, it is impossible to have two insurance policies from two different countries for one cargo. Therefore, an LC clause was used against the law and as a result the Letter of Credit was in need of amendment⁶¹. The beneficiary is recommended to learn about the national law of the country of applicant and issuing a bank in order to prevent such possible risks.

⁵⁹ Ibid.

⁶⁰ Ibid.

⁶¹ Ibid.

4.2.4. Fraud of Applicant in Manipulating Data of another Letter of Credit

While doing business with new and unknown business partner, the beneficiary should be careful and aware of a possibility to face with different fraud schemes used by the applicant and use the services of his own bank or individual experts to prevent such risks. Such fraud schemes can be sending a bogus Letter of Credit to the beneficiary which was stolen from the issuing bank or manipulating the data of another Letter of Credit and sending it to the beneficiary.

Hao and Xio discuss the case of a Chinese Company which was advised about a credit in her name opened by a company in Hong Kong.⁶² While checking LC's content and with the help of an advising bank, the beneficiary found out that in fact the LC in his favor had another beneficiary and another name of the beneficiary, the credit amount and the date of shipment were changed by the applicant.

4.2.5. Risk of Documentary Discrepancy

The standard for examination of documents has been set in Article 14 of UCP 600:

“Article 14 Standard for Examination of Documents

a. A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying Presentation.

d. Data in a document, when read in context with the credit, the document itself and international standard banking practice, need not be identical to, but must not conflict with, data in that document, any other stipulated document or the credit”.

As a result of the complex process and interactions between the bank and the traders in LC transaction, there is a high probability for occurrence of the documentary discrepancy. The risk of financial loss and dishonoring presentation by the bank will raise when there is no possibility to resolve discrepancies. Such discrepancy can be considered as a significant risk for the exporter as according to ICC⁶³ the global rate of documentary discrepancy in LC transaction is about 60–70%.

⁶² Ibid.

⁶³ ICC Thailand 2002, *Examination of documents waiver of discrepancies and notice under UCP500*, ICC Thailand, (last visited on 10 January 2017), <http://www.iccthailand.or.th/article2.asp?id=9>.

Documentary discrepancy rate in the USA is considered about 73%⁶⁴ while in the UK it has been estimated to have amounted up to 50–60%⁶⁵. Despite the fact that the costs of the documentary discrepancy have not been studied globally, but SITPRO study showed “that in 2000 the UK lost 113 million through non-compliant documents being presented under Letters of Credit”⁶⁶.

As it was mentioned before, the majority of discrepancies in practice of Documentary Letters of Credit include inconsistent data⁶⁷, discrepant documents of transport⁶⁸, mistakes in drafts⁶⁹, drafts without signature and inconsistent invoice with the credit⁷⁰, inadequate insurance⁷¹, and documents with wrong signature⁷². Therefore, the beneficiary is strongly recommended to put in place necessary check and balance systems in order not to bear the financial burden of the documentary discrepancy in LC operation.

4.3. Risks for the Bank

The international trade finance because of its short term, self-liquidating and secured nature is less risky for banks than other types of financing operations⁷³. However, it does not mean that banks neglect relevant risks to international trade in general and LC operation in particular. Banking risks in international LC operation can be divided into two main groups of Marco and Transactional Risks.⁷⁴

⁶⁴ R. J. Mann, *The role of letters of credit in payment transactions*, Michigan Law Review 2000, Vol. 98, No. 8, pp. 2494-2547.

⁶⁵ SITPRO Ltd. 2003, *Report on the use of export letters of credit 2001/2002*, SITPRO London, 2005, Letters of credit – an introduction, SITPRO Ltd, (last visited 10 January 2017).

⁶⁶ SITPRO Ltd. 2003, *Report on the use of export letters of credit 2001/2002*, SITPRO London, p. 2.

⁶⁷ Article 14(d) UCP 600.

⁶⁸ Article 19 UCP 600.

⁶⁹ Article 18(c) UCP 600.

⁷⁰ Article 28 UCP 600.

⁷¹ Baker B. *Exporting Against Letters of Credit* available at <http://www.financepractitioner.com/operations-management-best-practice/exporting-against-letters-of-credit?page=1> (last visited 10 March 2017).

⁷² Article 34 UCP 600.

⁷³ UNCTAD, 1999, *Documentary Risk in Commodity Trade*, UNCTAD/ITCD/COM/Misc. 31.

⁷⁴ *Ibid.*

4.3.1. Macro Risks

The macro risks include external risks which affect the bank's role in LC operation like country risk and bank's risk. Due to many reasons such as economic and political stability, trade relations, rule of law and the existence of law enforcement institutions, countries are divided into different risk categories. In dealing with high-risk countries, banks either reduce the credit limit or imposes higher charges of issuing, confirming or negotiating LCs. On the other hand, not all involving banks in LC operation have the same financial and reputation weight. Therefore, banks should consider elements of defining creditworthiness of their counter parts in other countries in order to secure receiving payment by them.

4.3.2. Transaction Risks

In addition to macro risks, while being involved in international LC transaction, banks are exposed to related risks of security of transaction. LC transaction risks are of three types: firstly, financial status of the customer and his credit history which is relevant to the risk of not receiving reimbursement after making payment to the beneficiary. Secondly, the nature of the traded goods: the account party might go bankrupt as a result of high level of fluctuation in price of goods and as eventually it may be possible for the issuing bank not to receive reimbursement. Therefore, banks should consider the risk of issuing LC for commodities with highly volatile market. The third and final element of transitional risk is the bank's position and her relations with other involved banks in the international LC operation⁷⁵. The issuing bank faces major risks as it is recommended to check not only the creditworthiness of her own customer but also the credibility of the beneficiary and her bank as well. Exporter's bank also should check the reliability of issuing, confirming and negotiating banks overseas. There are occasions for fraud which can result in honoring LC by confirming the bank when the applicant does not accept the documents and the issuing bank does not effectuate the reimbursement accordingly. In such situation, the only solution for confirming the bank includes recourse clauses in her contract of negotiation with the beneficiary in order to prevent the risk of fraud.

⁷⁵ Ibid p. 20.

5. Conclusion

The importance of Documentary Letters of Credit as a method of payment in international trade which can balance conflicting interests of exporter and importer by transferring the payment risk from the importer to the issuing bank is constantly growing due to constant development in trade among nations. Despite the fact that the main objective of LC operation is to reduce the level of risk in the international trade, still all involved parties to international LC transaction face numerous types of risk which can create problems in smooth operation of trade between the importer applicant and the exporter beneficiary. Some risks even affect the banking operation involved in LC transaction. The current paper tried to shed light on different risks which either party might face in the international LC transaction in order to warn them against the existence of such risks and prepare them to adapt proper risk management methods.

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