Managing The Risk of Discrepancies in Documentary Letters of Credit: Study of Export DLCs in Estonia

The increasing level of export trade can be considered as a double edged sword. While it increases possibility for access to new markets and extra profit for traders, facing with expected and unexpected risks of doing business overseas would be inevitable. Among others, payment risk is substantial hindrance in closing international export contracts. This particular risk has been approached by traders via invention of different methods of payment. Documentary Letters of Credit (DLCs) are one of such methods. They are popular in export trade due to transferring the risk of payment from importer as an individual to bank as an institute with much higher financial standing. However, full documentary nature of international DLC transaction makes it vulnerable to the risk of discrepancy. As a result, instead of reducing the payment risk in export trade, DLCs can face international traders with high risk of rejection of documentary presentation by banks. Such rejection can bring about serious consequences for exporters as rectification of discrepancies might be time consuming, costly or even impossible. Therefore, outcome of rejection of documentary presentation by bank for exporter can vary from being paid with delay and need for absorption of extra costs of rectifying documentary discrepancies to incurring bad debt due to inability for rectifying discrepancies before expiry date of the credit.

The object of this research is the Enterprise Risk Management (ERM) in DLC operations. The absence of an empirical study to analyse the level of discrepancies and imposed losses resulting from it on Estonian exporting firms was the main idea behind the choice of the current research topic. In practice, this research intended to fill two main research gaps. First, according to the personal experience of the author and after conducting an extensive literature review it became evident that the Export Letter of Credit Business Risk Management model (ELCBRM model designed by Mr. Roberto Bergami) is the only ERM model describing the risk of documentary discrepancy from the perspective of exporters. However, the model is fully conceptual and does not use quantitative methods. Second, there is limited research on DLC operations in the Estonian international trade landscape and almost no public data is available regarding documentary discrepancy in Estonian export DLCs.

The study filled identified research gaps by further development of ELCBRM model of Bergami and introduction of Expanded Oriented ELCBRM model, validation of the applicability of the Expanded ELCBRM model in the context of the Estonian export landscape via conducting an empirical study, identifying the vulnerability of Estonian exporting firms to losses resulting from documentary discrepancies occurring in their DLC operations, and showing the possibility to use the Expanded Oriented ELCBRM model in different contexts for describing the use of DLCs in export trade.

Hamed Alavi
MANAGING THE RISK OF DISCREPANCIES IN DOCUMENTARY LETTERS OF CREDIT: STUDY OF EXPORT DLCs IN ESTONIA

Thesis for the Degree of Doctor of Philosophy
by
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To My Family
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CONTENTS

Acknowledgments 5
Contents 7
List of Original Publications 8
Figures and Tables 9
Table of Abbreviations 10
Introduction 11
1. Enterprise Risk Management in the DLC Operations 15
   1.1. DLC Operation 15
   1.2. Key Principles of DLCs 16
       1.2.1. The Principle of Strict Compliance 17
       1.2.2. The Principle of Autonomy 17
   1.3. Risk Management 18
       1.3.1. The concept of risk management 18
       1.3.2. The risk of documentary discrepancy 20
       1.3.3. Export Letter of Credit Business Risk Management Model 21
   1.4. Fraud in the DLC Operations 24
   1.5. Conclusions 26
2. Operationalising the ELCBRM Model 27
   2.1. Expanded ELCBRM model 27
   2.2. Conclusions 29
3. Empirical Research 31
   3.1. Research Design 31
       3.1.1. Exporters’ Survey 35
       3.1.2. Bankers semi structured interview questions 35
   3.2. Data Collection 35
   3.3. Data Analysis 36
   3.4. Conclusions 38
4. The Results of Empirical Survey 39
   4.1. Estonian Export Landscape 39
   4.2. Documentary Discrepancies in the DLC Operations 41
   4.3. Recommendations 44
Conclusion 46
References 49
Appendix 1: Types of Variables and Their Range 53
Appendix 2: Exporters Survey Questionnaire 55
Appendix 3: Interview questions for Trade Finance Officers in Banks 63
Publications 65
LIST OF ORIGINAL PUBLICATIONS

This dissertation is based on the following publications by the author:
I. Alavi, H. 2018 a, (accepted), Mitigating the Risk of Documentary Discrepancy in Process of Estonian Export Letters of Credit Transaction, XV International Conference Multidisciplinary Aspects of Production Engineering (MAPE 2018), 05-08 September 2018, Poland
III. Alavi, H. 2017a, Risk Management Techniques and their Application to Documentary Discrepancy in Letter of Credit Transaction, European Journal of Economic Studies, 6(1), 4-17
FIGURES AND TABLES

Figure 1: Export Letter of Credit Business Risk Management Model  

Table 1: Relations between survey questions and variables of the expanded ELCBRM model  

Table 2: Correlation between the controlled variables and the variables describing documentary discrepancies  

Table 3: Contributions of the Author’s publications
# TABLE OF ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>CFR</td>
<td>Cost and Freight</td>
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<tr>
<td>CIF</td>
<td>Cost Insurance and Freight</td>
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<tr>
<td>CIP</td>
<td>Cost and Insurance Paid to</td>
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<td>CPT</td>
<td>Carriage Paid to</td>
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<td>DAP</td>
<td>Delivery at Place</td>
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<td>DAT</td>
<td>Delivery at Terminal</td>
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<td>DDP</td>
<td>Delivery Duty Paid</td>
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<td>DLC</td>
<td>Documentary Letters of Credit</td>
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<td>ELCBRM</td>
<td>Export Letter of Credit Business Risk Management</td>
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<td>EXW</td>
<td>Ex Work</td>
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<tr>
<td>ERM</td>
<td>Enterprise Risk Management</td>
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<tr>
<td>FAS</td>
<td>Free Alongside Ship</td>
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<tr>
<td>FCA</td>
<td>Free Carrier</td>
</tr>
<tr>
<td>FOB</td>
<td>Free on Board</td>
</tr>
<tr>
<td>ICC</td>
<td>International Chamber of Commerce</td>
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<tr>
<td>INCOTERMS</td>
<td>International Commercial Terms</td>
</tr>
<tr>
<td>UCP</td>
<td>Unfired Customs and Practices for Documentary Credits</td>
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INTRODUCTION

The current positive trend of global economic development can be considered the main driving force behind promotion of international trade. Despite the fact, that international trade is more profitable and promising than national trade, it is also a risky practice. Regardless of whether you are an importer or exporter, the payment problem is one of the riskiest aspects of doing business with other countries. As a result, and in the course of time, the trader’s society has developed different types of payment methods applicable to international business. Such payment methods can be listed from the exporter’s perspective and from least risky to riskiest as follows: Open Account, bill of exchange or Documentary Collection, Documentary Letters of Credit (DLC) and prepayment (Dolan 2006, 475).

Among all the above mentioned methods, DLCs are known as the most favourable method of payment for initiating transactions between importer and exporter in different countries with no solid information about each other’s financial standing and trade background (Klein 2006, 31). By shifting the payment risk from the importer to an irrevocable promise of payment by the bank, the DLC will guarantee receipt of payment for shipped goods by the exporter under the condition that the payment will take place after presentation of documents that are one hundred percent compliant as stipulated in the credit by the exporter (Garcia 2009, 88). In practice, the bank purchases fully compliant tender of documents from the exporter instead of the goods shipped to the importer. However, the complex nature and operation of the DLC may result in a situation which can create a discrepancy in the tendered documents and result in dishonouring the tender by the bank or a request for the correction and resubmission of the documents (Bergami 2010, 165).

The definition of a discrepancy and the types of discrepancies in the documents tendered, as well as different options for the bank in response to a discrepant tender by the exporter, are regulated by the International Chamber of Commerce (ICC) under the Unified Custom and Practices for Documentary Letters of Credit (UCP). The UCP 600 has been in force since 2007 (Gao & Buckley 2003, 235). The UCP 600 provides that the DLC operation is subject to two main principles of autonomy and strict compliance. Where the Principle of Autonomy refers to the independence of the rights and duties under the DLC for those under an international sales contract, the principle of strict compliance requires the presentation made by the beneficiary to be strictly compliant with the terms and conditions of the credit to make him eligible to be paid by the issuing bank.

However, there is not yet a concrete solution for the problem of noncompliance in tendered documents, as the notion of strict compliance has different meanings in different jurisdictions. With reference to the ICC, the world-wide documentary discrepancy rates against the DLC are between 60% to 70%. These figures appear to be consistent with studies in the USA reporting discrepancy rates of 73%, and
the UK with 50% to 60% (ICC Bangkok 2002). According to SITRPRO (2003), the cost of discrepancies is not well researched and difficult to establish. However, it was estimated that in 2000 the UK lost £113 million through non-compliant documents being presented under letters of credit (SITPRO Ltd. 2003). Where discrepancies cannot be resolved, the result may be financial loss to the exporter because the issuing bank rejects the documents. This is a significant issue from the risk management point of view (Bergami 2006, 49).

In practice, the initial point of raising the problem of documentary discrepancy in the international DLC transaction is the lack of exporter’s control over the production of all documents. Some documents are produced internally by the exporter’s staff while others are produced by third parties (e.g. insurance, certificate of inspection and transport documents). As a result, the application of a proper risk management system which covers internal and external sources of risk seems not only useful but also necessary in reducing the cost of discrepancies for the exporters.

In line with modern risk management practice, Enterprise Risk Management (ERM) is known as an efficient way to identify and reduce existing risks to the proper operation of a business. ERM takes a multi-dimensional and holistic approach to risk management by studying the relevance among different external and internal sources of risk in the studied phenomenon. Although, there are many ERM models designed for the banks and insurance organisations involved in international trade, scholars agree on the absence of a suitable risk management model for mitigating trade finance risks from the perspective of exporters (Bergami 2011). The first and only available risk management model specifically applicable to DLC risk management has been introduced by Roberto Bergami (Bergami, 2011). The Export Letter of Credit Business Risk Management Model (ELCBRM model) was adapted from the Business Risk Model that McNamee proposed in 2000 (McNamee 2000, 46).

**The object of this research is the ERM in DLC operations.** The absence of an empirical study to analyse the level of discrepancies and imposed losses resulting from it on Estonian exporting firms was the main idea behind the choice of the current research topic. In practice, this research intends to fill two main research gaps. First, according to the personal experience of the author and after conducting an extensive literature review it became evident that the ELCBRM model is the only ERM model describing the risk of documentary discrepancy from the perspective of exporters. However, the model is fully conceptual and there is no evidence available indicating its applicability based on tests using quantitative methods. Second, there is limited research on DLC operations in the Estonian international trade landscape and almost no public data is available regarding documentary discrepancy in Estonian export DLCs.

The **research problem** is formulated as follows: **How can the exporter’s risk of documentary discrepancy be managed (reduced) in the operation of DLC in Estonia?**
The research problem was decomposed into the following **research questions**:  
1) What is the compliant presentation of an international DLC transaction under law? (RQ1)  
2) How can the risks in the framework of export DLC operations be described? (RQ2)  
3) Why do documentary discrepancies occur in practice in Estonian exports using DLC operations? (RQ3)  
4) What measures should be taken by Estonian exporters to reduce the risk of documentary discrepancy in export DLC operations? (RQ4)

The research design used the following logical sequence of steps:  
1) Analysis of the legal framework for using DLCs in export operations (RQ1);  
2) Analysis of existing ERM models describing the use of DLCs in export operations (RQ2);  
3) Development of an appropriate ERM model describing the use of DLCs in export operations (RQ2);  
4) Conducting a survey of Estonian exporters using the model developed (RQ3);  
5) Analysing the results of the survey (RQ3);  
6) Drawing conclusions and recommendations from the analysis conducted (RQ4).

In seeking answers to RQ1 and part of RQ2, the author used the doctrinal method. In designing an ERM system model appropriate for conducting an empirical study of export DLC operations and associated discrepancies (RQ2), the author followed the design research method. In seeking answers to RQ3 and RQ4, the author used a case study approach. The empirical study of export DLC operations and associated discrepancies in Estonia has been based on quantitative and qualitative data collected by way of an administrative survey among Estonian export companies and conducting semi-structured interviews with Estonian banks active in the practice of export trade finance.

Publications IV, V, VI and VII answer RQ1. Publication III answers RQ2. Publications I and II provide answers to RQ3, and last but not the least, answers to RQ4 are provided in chapter 4 of this paper.

The outline of the current thesis is as follows. The first chapter describes the principles of ERM in DLC operations and introduces the ELCBRM model. The second chapter develops the Expanded ELCBRM model applicable for the quantitative studies of risks associated with documentary discrepancies in DLC operations. The third chapter describes the empirical study conducted within the framework of the Estonian export landscape. And, the fourth chapter presents the analysis of the results of this empirical study and the recommendations elaborate
1. ENTERPRISE RISK MANAGEMENT IN THE DLC OPERATIONS

This chapter will focus on the main principles of using DLCs under the UCP 600, the principles of risk management and the application of ERM in DLC operations. Although this research does not intend to approach the risk of documentary discrepancy in DLC operations from the legal perspective, it is necessary to refer to the legal sources of discrepancy risk due to their interdependence with the managerial aspects.

1.1. DLC Operation

Process of issuing a DLC starts with a request from a buyer (Applicant or Account Party) to his bank (issuing bank) in order to issue credit in favour of the seller (Beneficiary) based on the underlying contract of sales between the parties. As a result, the issuing bank will contact the beneficiary in his country to inform him about opening the credit in his favour. Due to the geographical distance between the issuing bank and the beneficiary, advice of the credit to the beneficiary will generally take place via a correspondent of the issuing bank in the beneficiary’s country (advising bank). The responsibility of the advising bank is only to inform the beneficiary about the credit having been issued in his favour, and it does not have any obligation of payment towards the beneficiary (Article 9a, UCP 600). As a result, the legal nature of the relationship between the issuing bank and the advising bank is considered a relationship between agent and principal (Gian Singh and Co Ltd v Banque de l’Indochine [1974] 1 WLR 1324 at 1238).

The beneficiary at this stage must compare the terms and conditions of the credit with the terms of the underlying contract. If any discrepancy exists at this stage, the beneficiary is entitled either to reject the credit or require amendments. After approval of the credit by the beneficiary, the issuing bank will enter into a contract with the beneficiary to provide him with the price of the merchandise in return for complying with the documents required in the credit. As a result, any given credit will have at least three parties:

- the Issuing bank,
- the Beneficiary, and
- the Applicant.

However, in practice the number of parties may be more than three. It may happen that the issuing bank asks the advising or any other bank in the country of the seller to provide the credit on her counter, which is a highly appreciated option for the beneficiary who will be paid in his own country rather than in the country of the buyer. In this case, the bank which provides the credit on her counter is considered the nominated Bbnk (UCP 600 – Article 2). In some cases, the seller may ask for a
higher guarantee for the payment, which is already provided by the issuing bank. In this case the confirming bank will add her irrevocable commitment to cover the payment of the credit to the beneficiary in addition to the issuing bank.

In the second phase, the buyer will require the issuing bank to open credit in favour of the exporter. If the issuing bank agrees to issue the credit, the Importer (account party) will pay the bank the price of the goods sold to him in return for receiving the confirmatory documents stipulated in the credit note presented to the bank by the beneficiary (Article 7- UCP 600). If the parties decide to credit the beneficiary via a bank in his own country, then the advising bank will contact the beneficiary to inform him about issuing the credit in his favour. If the credit requires the involvement of the nominated bank or confirming bank, there will be a separate contract between the beneficiary and the nominated or confirming bank and the issuing bank and the nominated and confirming bank. The advising bank may or may not agree to act in the capacity of a nominated and/or confirming bank.

As a result, the beneficiary ships the goods to the account party and presents confirmatory documents stipulated in the credit to the issuing bank, nominated bank or confirming bank. The nominated bank will check the documents and in the case of conformity, they will pay the beneficiary based on the authorisation of issuing bank (Längerich 2000, 105), transfer the documents to the issuing bank and wait for reimbursement (Article 7c, UCP 600). The issuing bank also checks the documents and in the case of their conformity will reimburse the nominated or confirming bank, debit the account of the applicant and inform him to come and receive his documents.

As mentioned earlier, most of the time the credit will require the involvement of a nominated bank and confirming bank as the issuing bank is not located in the country of the beneficiary and it is difficult for him to confirm the authenticity of the signatures from the issuing bank (Längerich 2000, 106).

Publications VI and VII provide an in-depth analysis of the complex processes and relevant principles associated with DLC operations. In addition, the papers offer a thorough analysis of the activities undertaken at each step of the transaction and the nature of the relations between the parties to the DLC operation.

1.2. Key Principles of DLCs

The UCP 600 explains that protecting the flow of international trade and safeguarding the operations using the DLCs are subject to two main principles:

- the Principle of Strict Compliance, and
- the Principle of Autonomy.
1.1.1. The Principle of Strict Compliance

The principle of strict compliance expresses that the issuing bank’s undertaking to honour the credit is effective only upon presentation of complying documents, which are stipulated in the credit by the beneficiary. On the other hand, in explanation of strict compliance, the general law of agency provides that an agent (issuing bank) will be entitled to reimbursement from an applicant only when acting in accordance with the applicant’s instructions (King 2003, 14). Therefore, banks who act as agent for an applicant in DLCs will receive reimbursement when honouring the credit against presentation of complying documents. The standard for examining documents is described in Article 14 of the UCP 600:

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.

b) 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.

Contrary to the Principle of Autonomy, the principle of strict compliance protects the interests of the applicant under the DLC process, which requires shipment of the promised goods by the beneficiary before actualization of the payment. There is an ongoing scholarly debate about what constitutes the complying presentation, which can be traced to legal cases (Botosh 2000, 183). The most important question may be how to identify a non-complying presentation (Krazovska 2008, 25).

There are two main theories regarding the determination of documentary compliance: The Doctrine of Strict Compliance and the Doctrine of Substantial Compliance. Taking a doctoral and comparative approach to the relevant legal cases in international trade, Publication VII (Alavi 2016c) provides a comprehensive picture of the doctrine of strict and substantial compliance, which are the fundamental notions in defining documentary discrepancy in DLC operations.

1.2.2. The Principle of Autonomy

The second fundamental principle in DLC operations is the Principle of Autonomy. This principle has been appreciated in national and international legal systems. The principle has been considered a “cornerstone of the commercial validity of letters of credit”, and “the engine behind the letter of credit” (Arkins 2000, 31). The Principle of Autonomy has been clearly mentioned in Article 4 of the UCP 600:

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 Principle of Autonomy and Article 4 of the UCP 600, the beneficiary 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 the payment based on the arguments related to the performance of the underlying contract. Therefore, even in cases of an argument on the performance of the underlying contract the account party and the issuing bank have no other choice than to pay the beneficiary upon presentation of the complying documents and seek remedy by suing him for a breach of the underlying contract. As a result, the Principle of Autonomy has been considered a means of promoting international trade by following the logic of “pay first, argue later” (Dolan 2006, 480).

The Principle of Autonomy also has been considered by scholars as the foundation for smooth DLC operations (Dolan 2006, 480):

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 DLC system. That system of financing would break down completely if a dispute between the seller and buyer was to have the effect of “freezing” the sum in respect of which the letter of credit was opened.

Publications IV and VI together offer the informed reader an in-depth legal analysis of the Principle of Autonomy by taking the doctorial approach.

1.3. Risk Management

The presence of different parties in a DLC transaction makes it sensitive to different types of risk. Although this research only focuses on the risk of documentary discrepancy from the perspective of exporters, any single party (bank, importer or exporter) faces different types of risk with their own particular origins and outcomes, which need to be treated accordingly.
1.3.1. The concept of risk management

The roots of the ‘word’ risk go back to the Italian word risicare which means ‘to dare’. According to Christensen ‘to dare’ in Southern Europe in the Renaissance period could be: “a concept of action with uncertainty, potential benefit and possible injury or loss” (Christensen 2006, 10). In early 20th century, Knight recommended separating the concepts of risk and uncertainty from each other (Bergami 2011, 39). According to him, uncertainty will apply to the condition in which chances cannot be calculated and it is not possible to define the probability of an event (Knight, 1921). In the late 20th century and early 21st century, the area of risk management has been a subject of research for many scholars and interestingly, many of them attributed risk to a predictable or non-predictable event with clear negative consequences (Marshall 2001; Koller 2007). The abovementioned scholars agree to refer to the negative consequences of an event as risk, while positive consequences are considered an opportunity. As an outcome, risk is generally considered a negative issue, which emerges from the reality that “for too many organisations risk is a four-letter word that they try to insulate themselves from” (Merna & Al-Thani 2005).

Consequently, scholars such as Borge (2001), Chorafas (2001) and Sadgrove (2005) provide a definition of risk based on the negative aspects of risk. Borge (2001) defines risk as “… means being exposed to the possibility of a negative outcome”. Chorafas (2001) motions “risk as the chance of injury, damage or loss; a hazard”. Sadgrove (2005) explains risk as “… the possibility that a hazard will cause loss or damage”, and the Committee of Sponsoring Organisations of the Tredway Commission (2004) provides that “risk is the possibility that an event will occur and adversely affect the achievement of objectives”.

Such a negative meaning of risk has also affected definitions of risk management provided by scholars. For example, risk management: “… is the practice of protecting an organisation from financial harm” (Blake 2003, 58) and, “… as being concerned with identifying and managing a firm’s exposure to financial risk” (Kaen 2005, 423). Some scholars indicate ‘opportunity’ in providing their definition: “Risk management is the application of analysis techniques and the definition of measures to quantify the amount of financial loss (or gain) an organisation is exposed to” and “if you approach risk management as a discipline …you are concerned with the opportunity for gain as well as loss” (Gorrod 2004, 3).

Risk management has been developing since the early 1960s due to changes in global market demand and technological developments (Tye1980, 15). With reference to Sadgrove (2005), Pitinanondha (2008) argues there are three eras of risk management. Pitinanondha’s (2008) work indicates a change in the attitudes of businessmen from considering risk as an internal problem to an internal and external issue, and this has resulted in changing risk management techniques from reactive strategies using insurance to proactive strategies that take preventative measures.
However, as mentioned earlier, the literature on documentary discrepancy risk management in DLC operations is limited to the bank’s perspective and neglects the exporter’s perspective (Pridotkiene et al. 2006, 7).

ERM emerged in the 1990s as a concept and techniques for managing enterprise risk in a consistent and comprehensive framework (Dickinson 2001, 360). ERM takes a holistic approach to the interconnections among strategic, operational, financial and hazard risks from the perspective of an organisation (Scherz & Macaky 1998, 30‒32). The reason for the emergence of ERM was the failure of some high-profile companies due to a traditional approach to managing risk via “silo thinking” as an expression for decision-making using irrelevant organisational units and negligence towards the overall effect of decisions on the organisation as a whole (Scherz & Macaky 1998, 30‒32). Publication III (Alavi 2017a) studies the history of ERM in DLC operations, some ERM techniques and their applicability to managing the risk of documentary discrepancy in DLC operations.

1.3.2. The risk of documentary discrepancy

The risk of documentary discrepancy is among risks primarily affecting the exporter (Dolan 2006, 488). Despite the fact that strict compliance of the presented documents is stipulated in different jurisdictions as well as in the UCP, the non-harmonised approach of national laws to the definition of strict compliance can be considered a risk on its own. For example, English law requires the pure strict compliance of documents forming the presentation of terms and conditions to the DLC to qualify it for receiving the payment. However, the UCP 600 requires substantial compliance, which is much more flexible. The UCP even provides an acceptable level of tolerance in weight and packing list within the framework of the presentation of the amounts stipulated in the DLC.

It is also worth mentioning that the UCP 600 does not have the effect of law (Arkins 2000, 40). Despite its enormous popularity among the international trading community, it is a set of rules produced by the International Chamber of Commerce (ICC). Since the ICC is not a public authority, its productions also cannot be regarded as binding by law per se. As a result, the UCP 600 will be binding only when it is expressly mentioned as the applicable law in the credit itself (Buckley & Xiang 2002, 664). Not referring to the UCP 600 will increase the risk of uncertainty in defining the applicable law to the credit as well as the risk of the inconsistent approach of national laws in different countries to the problem of documentary compliance. Such inconsistency may result in the risk of discrepancy in presentation under a given applicable law while the same issue is not considered as a discrepancy under the UCP or other national laws (Malek & Quest 2009, 320).

There are many credit risk evaluation methods developed for banks, to help them to evaluate the risks of their different products. However, no model has been developed for evaluating the credit risk from the point of view of an exporter in the
DLC transaction (Pridotkiene et al. 2006, 7). Nevertheless, it is essential to start by identifying major types of documentary discrepancies in DLC operations in which the exporter may face such a risk.

The majority of the discrepancies in the practice of DLC operations include inconsistent data (Article 14(d), UCP 600), discrepant documents of transport (Article 19, UCP 600), mistakes in drafts (Article 18(c) UCP 600), drafts without signatures and inconsistent invoices with the credit (Article 28 UCP 600), inadequate insurance, and documents with the wrong signature (Article 34, UCP 600).

1.3.3. **Export Letter of Credit Business Risk Management Model**

The analysis of existing ERM models and standards has shown that the Export Letter of Credit Business Risk Management (ELCBRM) model (Bergami, 2011) is the only ERM model suitable for describing the risk of documentary discrepancy in international DLC operations from the exporter’s perspective. The ELCBRM model was adapted from the Business Risk Model proposed by McNamee in 2000 (McNamee 2000, 46).

The model was developed as part of research aiming to (Bergami, 2011, iii):

a) Investigate why the Letter of Credit is chosen and discover whether in this process enterprise risk management principles are adopted,

b) Investigate the level of Letter of Credit documentary discrepancy rates for Australian manufacturing exports to ASEAN countries, and compare these rates with existing literature,

c) Determine the factors contributing to this discrepancy and estimate their financial impact,

d) Suggest improvements for the future.

In relation to the objectives above it was found that:

a) There is some evidence that ERM approaches are being pursued through the use of Letter of Credit templates;

b) Discrepancy rates appear to be about 26%, and these are much lower than earlier ICC estimates;

c) The highest number of new exporters has been micro enterprises with little experience and expertise in Letter of Credit transactions and this lack of knowledge leaves these organisations exposed to financial losses through documentary discrepancies;

d) There is a requirement for training programs specifically related to risks involved in Letter of Credit transactions and the means available to reduce documentary risks following the suggestions of the Export Letter of Credit Business Risk Model.

Bergami’s model consists of three risk groups: Environmental Risks, Behavioural Risks and Process Risks (see Figure 2). Bergami describes these risks in a conceptual manner, i.e. fully qualitatively (Bergami, 2011).
The **Environmental Risks** include four main sub categories: country risk, customer risk, and bank risk as well as opportunity costs (common with Behavioural Risks).

It is important for the exporter to consider the insurability of these risks. Therefore, the insurance company’s lack of interest in insuring either of the environmental risks in a DLC transaction will send a strong signal to the exporter to cancel the deal or require the other party to provide a proper risk management guarantee.

- **Country Risk**: a high risk of being exposed to different national regulations results in the exporter being strongly advised to conduct a country risk assessment in any single occasion of trade. A useful resource in conducting a due country risk assessment can be the OECD Country Risk Assessment Model, the World Bank Doing Business, and the reports of Transparency International. The exporter may also use some personalized models to define financial and regulatory risk in the country of destination including: the Checklist Approach, Delphi Technique, Quantitative Analysis, Inspection visits or a combination of the abovementioned techniques.

- **Customer Risk**: by its virtue, the choice of DCL as a method of payment in international trade signifies the existence of some problems with the customer. The problems can either be the lack of a trading history between the exporter and the customer, a transaction level higher than the credit standing of the customer or it taking longer than the exporter’s expectation to be paid for the transaction. Logically, the exporter expects the customer to solve such problems by providing a DLC from a reputable bank. The inability of the customer to provide the credit in accordance with the terms of the underlying contract and in a timely manner will be a good sign for the exporter either to walk away from the deal or require prepayment as the most secure method of payment.

- **Bank Risk**: in DLC operations, the issuing bank which guarantees the payment for the contracted goods to the exporter is generally located in the importer’s country. By advising the credit to the exporter, the local bank assumes responsibility for authenticating the credit. If the advising bank refrains from advising the credit, a strong signal is sent to the exporter to doubt the credibility of the issuing bank. It is also possible to request a confirmed DLC to manage the banking risk in the international DLC transaction.

- **Opportunity Costs**: Regarding opportunity costs, Bergami (2010) comments on the cost of discounting the credit as a potential risk for the exporter.

**Behavioural Risks** include three elements, where one is also common to Environmental Risks and another is common to Process Risks.

- **Dysfunctional Places**: In McNamee’s model, dysfunctional issues like sexual and behavioural abuse or a violent work place do not affect the DLC operation directly. However, a direct effect can be witnessed in the case of a stressful working environment.
• Opportunity Costs: In the context of the DLC transaction, opportunity costs refer to the internal documentation process in the exporter’s firm, or the organisational processes of the third parties involved in the process of document production. Based on the principle of strict compliance, the exporter will bear all costs of the documentary discrepancy regardless of who is guilty in the production of a discrepant document. As a result, the exporter should consider the implementation of a due check and balance system to prevent any respective loss in the process of presenting the DLC documents to the bank.

• Productivity Loss: The employee’s negligence in the process of producing the DLC documents could result in bearing huge losses by the exporter. The risk of incurring such losses can be mitigated by implementing in-service training.

Process Risks are defined under six titles, where one is common to Behavioural Risks and one to Environmental Risks.

• Hazards: Bergami (2010) divides hazards in DLC transactions into pre-shipment and post-shipment hazards. While the Pre-Shipment Hazards are defined as delivery delays to the carrier resulting in missing the shipping deadline, Post-Shipment Hazards might be damage to the cargo during shipment after reaching the destination or while offloading the cargo (in the case of using delivery terms by the exporter). Such risks can be mitigated by the procurement of a proper insurance policy.
• Errors, Omissions and Delays: These risks are related to discrepancies in the documents as a result of organisational problems on the part of the exporter or their party issuer of documents.

• Fraud: The risk of fraud may occur because of either false sales and shipping or misrepresentation of documents by an unscrupulous beneficiary. The Principle of Autonomy in international DLC transactions will protect the exporter in the case of fraud in the underlying contract or false sales. Therefore, as will be discussed in the next section, fraud is not a relevant issue within the existing risks to the compliance of the presentation.

• Productivity Loss is basically caused by errors requiring corrective action.

Bergami used the ELCBRM model to design his empirical research aiming to map the risks associated with DLC operations in Australian exports to ASEAN. The research followed 10 objectives aiming to collect descriptive statistics about the operational characteristics of companies using DLCs, the occurrence of documentary discrepancies and associated losses (Bergami, 2011, 195).

1.4. Fraud in the DLC Operations

The ELCBRM model considers fraud as a part of Process Risks relevant to compliant presentation. The fraud occurs when documents presented by the beneficiary are strictly compliant with the terms and conditions of the credit, but he does not perform his duties under the underlying contract of sales. In fact, the fraud is recognized as an exception to the principle of autonomy in DLC law, which has been emphasized in Article 4a of the UCP 600:

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.

According to Article 5 of UCP 600, the bank deals with documents not goods or services, which means that banks deal with written presentations not facts (Harfield, 1974, 69). According to Dolan (1988, 121):

The fundamental principle governing documentary letters of credit and the characteristic which gives them their international commercial utility and efficacy is that the obligation of the issuing bank to honour the draft on a credit when it is accompanied by documents which appear on their face to be in accordance with the terms and conditions of the credit is independent of the performance of the underlying contract for which the credit was issued.

The following citations from the research literature illustrate the issue of fraud:

Under the law of letters of credit, the beneficiary requiring payment does
not have to show the issuer that it has properly performed its duties under the underlying transaction. All it needs to do is to produce documents on their face complying with the terms and conditions of the letter of credit. This leaves a loophole for unscrupulous beneficiaries to abuse the system and defraud the other parties involved. A simple example in a commercial letter of credit transaction would be a situation where the seller is paid by the issuer upon presenting documents complying on their face with all the requirements set out in the letter of credit, but the buyer does not receive the goods because the documents are in fact pure forgeries. (Gao, 2010, 48)

The separation in law of the documents from the actual performance of the underlying transaction is absolutely necessary for credits to fulfil their essential commercial function and creates a loophole for unscrupulous beneficiaries to abuse the system. Perpetrators of fraud (“Fraudsters”) may thus utilize letters of credit to obtain others’ money by presenting forged or fraudulent documents. The classic example is where the seller gets paid under a letter of credit by presenting forged documents that comply in form with the requirements in the credit, yet the buyer receives only a shipment of worthless rubbish instead of the expected goods. (Buckley and Xiang, 2002)

Therefore, the beneficiary does not have to prove the fulfilment of his obligations in the underlying contract and only presentation of complying documents will entitle him to receive payment from the issuing bank. As a result, strict implementation of the autonomy principle will create three distinctive scenarios regarding presentation of documents by the beneficiary.

First, the beneficiary presents complying documents and performs his obligations under the sales contract with the account party. As a result, the bank will allow payment after checking the documents. Second, the beneficiary presents non-complying documents while performing his obligations under the contract of sales with the account party. In such a situation, the bank may or may not authorise the payment to the beneficiary (the bank may ask for a waiver from the account party or corrections from the beneficiary).

The third scenario takes place when the beneficiary presents documents complying with the terms of credit but does not perform his obligations under the sales contract with the account party. On such an occasion, strict application of the autonomy principle may lead to fraud by the beneficiary and injustice towards the account party who will bear the loss as the last person in the chain of the transaction.

In order to prevent the fraud, the law on letters of credit has created the fraud exception to the autonomy principle. However, the fraud exception has been approached by different scholars and national laws in different ways. The UCP 600, as the most popular set of applicable rules to the DLC operations, has left the fraud exception rule open to the relevant national law, which show a drastically non-harmonious approach to the subject matter.
Not even the definitions provided for the fraud exception rule are harmonious. Gao Xiang considers fraud exception in the DLC as “an extraordinary rule as it represents a departure from the cardinal principle of the law of letters of credits – the principle of independence. It allows the issuer or a court to view the facts behind the face of conforming documents and to disrupt the payment of a letter of credit when fraud is seen to be involved in the transaction” (Gao X 2002, 30). Schmitthoff (D’Arcy 2012, 210) mentions that the fraud exception rule “permits a court to consider evidence other than the actual terms and conditions of the credit and is founded on the maxim of ex turpi causanonoritur actio”. Conveying the message that a fraudulent beneficiary will not be able to find an action based on his wrongdoing. Raymond Jack refers to the fraud rule as an “exception to the rule that the contracts made in connection with credits are autonomous” (Malek &Quest 2009, 250).

Publication IV thoroughly analyses fraud in DLC operations within the existing international legal frameworks. It concludes that by virtue of its nature, the fraud has nothing to do with documentary discrepancy in the DLC operations and it needs to be excluded from the ELCBRM model.

1.5. Conclusions

This chapter provided an overview of the principles and regulations relevant to using DLCs for export operations. Bergami’s ELCBRM model, as the only available model describing external and internal risks related to documentary discrepancies in DLC operations has been introduced. The model is fully conceptual by its very nature and does not allow any quantitative description of the risks associated with documentary discrepancies. It has been demonstrated that fraud has no relevance to the problem of documentary discrepancy in the DLC operations. Therefore, fraud as an element of Process Risk needs to be excluded from the ELCBRM model.
2. OPERATIONALISING THE ELCBRM MODEL

This chapter will focus on operationalising the ELCBRM model in order to support studying the risk of documentary discrepancy in DLC operations and building the relevant ERM systems. This is achieved through the further development of the ELCBRM model into an Expanded ELCBRM model. The chapter describes two phases of operationalising the model proposed by Bergami:

- Phase 1: defining the variables describing different types of risk;
- Phase 2: grouping the variables into three categories: variables controlled by the exporter, variables non-controllable by the exporter, and variables describing documentary discrepancies.

2.1. Expanded ELCBRM model

The ELCBRM model is the only ERM model developed specifically for describing the risks in international DLC operations, particularly the risk of documentary discrepancy (see section 1.3.3). Having defined the shortcomings of the model including its pure conceptual (qualitative) nature – the absence of a quantitative aspect, and the presence of fraud as an element of Process Risks, the model needs amendment to make the (partially quantitative) description and research of risks leading to documentary discrepancies in the DLC operations possible. This will produce a model applicable for studying risks leading to documentary discrepancies in DLC operations and developing the respective ERM systems in exporting companies in different contexts, including the context of Estonian exporting companies (see Chapter 3).

Phase one has been undertaken after the elimination of fraud as part of the Process Risks in the ELCBRM. The Expanded ELCBRM model has been developed by adding variables describing different types and elements of risk, and variables describing the documentary discrepancies of the ELCBRM model. In doing this, the author partially used variables introduced by Bergami in his empirical study of Australian exports to ASEAN countries (Bergami 2011, 196–200). It must be emphasized that these variables were introduced in the context of the 10 objectives of this empirical research and were not intended to be applied outside the context of this particular research. A detailed description of the variables introduced in the context of Estonian exporting companies is presented in Appendix 1. The variables introduced belong to three types: ordinal, nominal and dichotomous.

The Environmental Risks for an exporting company are described by the following variables:

- Company size;
- Duration of export experience;
- Annual number of transactions;
• Type of industry;
• Choice of bank;
• Use of credit agencies and mercantile agencies;
• Method used for assessing the country risk;
• Reason for choosing DLC as a payment method;
• Type of DLC used;
• Maturity date of the payment;
• Number of confirmed DLC transactions;
• Bad debts resulting from a discrepancy in the DLC;
• Number of discounting practices for exporting firms;
• Possible reasons for using a discounting practice for exporting firms.

The Behavioural Risks for an exporting company are described by the following variables:
• Knowledge and skills required for international DLC operations;
• Experience of employees involved in international DLC operations;
• Training offered for employees involved in international DLC operations.

The Process Risks for an exporting company are described by the following variables:
• Choice of delivery term;
• Number of employees involved in international DLC operations;
• Mode of transport used;
• Use of freight forwarding services during the export operation;
• Necessity for issuing documents by third party organisations;
• Type of discrepancy;
• Frequency of documentary rejections by bank;
• Corrective action of choice by exporting company.

In order to use the model to analyse the reasons why documentary discrepancies occur in DLC operations, the variables of the Expanded ELCRBM model were divided into three groups:
• Variables controllable by the exporter;
• Variables not controllable by the exporter;
• Variables related to documentary discrepancy.

Variables Controllable by the Exporter:
• Type of industry,
• Export level to total sales,
• Choice of bank,
• Method used for assessing the country risk,
• Choice of delivery term (INCOTERMS),
• Required knowledge and skills for international DLC operations,
• Number of export documentation employees,
• Mode of transport,
• Third party documents issued,
• Corrective action of choice by exporting company.

The exporter has control over the abovementioned variables and uses them to mitigate the risks, in particular reducing the risk of documentary discrepancies.

**Variables Not Controllable by the Exporter** are:

- Company size,
- Years of export experience,
- Number of confirmed DLC transactions,
- Use of credit agencies and mercantile agencies,
- Bad debts resulting from a discrepancy in a DLC,
- Necessity for issuing documents by third party organisations.

The variables in this group are environmental variables and an exporter has no opportunity to use them to mitigate risks associated with DLC operations.

**Variables relevant to documentary discrepancy** are:

- Number of confirmed DLCs;
- Instances of discounting practice for the exporter;
- Use of freight forwarding services in the export process;
- Frequency of documentary rejections by bank;
- Proportion of the waiver of discrepancies given by the buyer;
- Relevant costs to rectify discrepancies;
- Type of discrepancy.

**Types of documentary discrepancy** encountered:

- Errors in the bill of exchange;
- Errors in the commercial invoice;
- Errors in the packing list;
- Errors in the transport document;
- Errors in the inspection certificate;
- Errors in the certificate of origin;
- Late shipment;
- Missed predetermined consignment;
- Delivery schedule;
- Documents presented after DLC’s expiry;
- Missing documents;
- Incorrect or partial shipment;
- Other

2.2. Conclusions

This chapter provided answers to RQ2 – How to describe risks in the framework of export DLC operations? The Expanded ELCBRM model developed here allows researchers to analyse possible causes of documentary discrepancies in export DLC
operations, which can be used to improve the ERM system of an exporter. The model has been used as the starting point to design the survey of Estonian exporting companies in the empirical section of the research, more specifically, to measure the correlation between variables controllable by the exporter and variables related to the documentary discrepancy in the context of Estonian exporting companies (see Chapter 3).
3. EMPIRICAL RESEARCH

This chapter is dedicated to empirical part of research. The research is aiming to answer to the RQ3: Why do documentary discrepancies occur in practice of the Estonian export DLC operations? The provides details of research design, data collection and data analysis process used in the empirical section of this research.

3.1. Research Design

The empirical study pursued two objectives:
- Mapping the Estonian export landscape – companies using DLCs as a method of payment and the mitigation of the associated risks;
- Revealing the interrelationships between the factors (variables) controllable by the exporter and the attributes related to documentary discrepancies in DLC transactions.

Mapping the Estonian export landscape sought to answer the following research questions:
1) What are the characteristics of the Estonian companies using export DLCs? 
2) What are the reasons for using DLCs as the method of payment for Estonian exporting companies?
3) What are the types of DLC used in Estonian exporting companies?
4) What is the estimated level of discounting practice exercised in Estonian exporting companies using DLCs?
5) What is the level of exposure to foreign exchange risk for Estonian exporting companies using DLCs?

Research questions concerning documentary discrepancies related to Estonian export companies using DLCs were as follows:
1) What is the magnitude and frequency of documentary discrepancies occurring in Estonian export companies using DLCs?
2) What is the estimated level of bad debts resulting from documentary discrepancies in Estonian export companies using DLCs?
3) What knowledge and skills are most important among documentary staff in Estonian exporting companies using DLCs?
4) What is the level of training provided to documentary staff in Estonian export companies using DLCs?

The data has been collected from two sources:
- Survey questionnaires completed by exporters;
- Interviews with banks.
The surveys aimed to measure the correlation between the variables describing documentary discrepancies as the outcome of applying the ERM system, and four variables controllable by the exporter:

- Level of export sales to total sales;
- Choice of INCOTERMS;
- Knowledge, skills, training and experience of employees involved in international DLC operations;
- Third party issued documents.

Among variables relevant to documentary discrepancy, the type of discrepancy was chosen.

The data collection was arranged to accommodate the realities of the export market in Estonia. There are only four banks active in international trade finance practices in Estonia, and the number of freight forwarders involved in forwarding practices is not sufficient to collect meaningful data via conducting a survey.
Table 1: Relations between survey questions and variables of the expanded ELCBRM model.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Survey Questions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company size, years of export experience, type of industry, and number of transactions, choice of bank, choice of delivery term, mode of transport, use of freight forwarders services during the export process and necessity for issuing documents by third party organizations</td>
<td>Company size (q3), years of export experience (q7), type of industry (q6), and number of transactions (q13), choice of delivery term (q24), mode of transport (q29), use of freight forwarders services during the export process (q27,28) and necessity for issuing documents by third party organizations (q26), choice of bank (q23)</td>
</tr>
<tr>
<td>Use of credit agencies and mercantile agencies, method used for assessing the country risk, DLC as payment method chosen</td>
<td>Use of credit agencies and mercantile agencies (q19, 20), method used for assessing the country risk (q14), DLC as payment method chosen (q15)</td>
</tr>
<tr>
<td>Type of DLC, maturity date of payment, number of confirmed DLCs</td>
<td>Type of DLC, maturity date of payment (q11, 12), number of confirmed DLCs (q18, 19)</td>
</tr>
<tr>
<td>Type of error, frequency of documentary rejection by bank, corrective action of choice by exporting firm, proportion of waiver of discrepancies given by buyer, relevant costs to rectify discrepancies</td>
<td>Type of error (q42), frequency of documentary rejection by bank (q39, 40), corrective action of choice by exporting firm (q46), proportion of waiver of discrepancies given by buyer (q46), relevant costs to rectify discrepancies (q48)</td>
</tr>
<tr>
<td>Bad debts in general export process, bad debts resulted from discrepancies in DLCs</td>
<td>Bad debts in general export process, and bad debts resulted from discrepancy in DLCs (q47)</td>
</tr>
<tr>
<td>Type of currency in the credit, forward contract used for managing risk exposure of the company</td>
<td>Type of currency in the credit (q20), forward contract used for managing risk exposure of the company (q21)</td>
</tr>
<tr>
<td>Variables</td>
<td>Survey Questions</td>
</tr>
<tr>
<td>--------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>What measures should be in place to prevent risk of documentary discrepancy in LC operation?</td>
<td>Required knowledge and skills for the DLC transaction (q22)</td>
</tr>
<tr>
<td>Required knowledge and skills for the DLC transaction</td>
<td>Number of export documentation employees (q3), number of years of experience for employees (q4) special training on DLC operations (q5)</td>
</tr>
<tr>
<td>Number of export documentation employees, number of years of experience for employees, special training on DLC operations</td>
<td>Number of discounting practice for exporting company (q49), possible reasons for such practice (q50)</td>
</tr>
</tbody>
</table>
3.1.1. Exporters’ Survey

A survey was conducted among Estonian exporting companies to gain knowledge from their experience with documentary discrepancies in export DLC operations. The survey questionnaire (see Appendix 2) was structured in three main sections (see Table 1):

- Business Environment and General information (questions 1–13);
- Risks of export trading (question 14–21);
- DLC operations (questions 22–50).

The type and range of variables (metrics) as well as their connection with different types of risk in the ELCBRM model are described in Appendix 1.

3.1.2. Bankers semi structured interview questions

Data collected from the exporter survey were supplemented by the results of the interviews with trade finance officers at Estonian banks active in the export trade finance area. There are only four banks in Estonia involved in the practice of international trade finance. Among them only three agreed to participate in the current research. As a result, in conducting the interviews with the trade finance departments of the banks, the survey method was replaced with a semi-structured interview. The interviews consisted of three main sections:

- Export information (questions 1–3);
- Export trading risks (questions 4–7);
- DLC operation risks (questions 8–13).

The details of these interviews cannot be disclosed due to confidentiality agreements. The results of the interviews were used to provide explanations for the results from the exporter survey (see Chapter 4).

3.2. Data Collection

The survey questionnaires were distributed to exporting companies after conducting a sample test with three companies. The test respondents were excluded from the main sample and the data were collected between June and September 2016 on the basis of DLC transactions done within the 2014/15 fiscal year. The interviews with the bank trade finance officers took place during the same period.

In practice, it was impossible to define the export target countries. This might have been due to the trade secrecy practiced by Estonian exporters. The trade finance officers in the banks also refrained from answering questions about the destination countries of Estonian export DLCs. As a result, the export target country was eliminated from the list of variables in the expanded ELCBRM model.
In total, 1,200 questionnaires were distributed among exporting companies in accordance with the data in the Estonian Export Directory (www.estonianexport.ee). The data collected from the interviews with bank officers show that in total 100 to 150 Estonian exporting companies use DLCs as a method of payment in conducting their international transactions. By the end of September 2016, 41 responses were collected, which is 27.3 per cent of the total population. As a result, the collected data were sufficient for this research, despite comprising a small proportion of the distributed questionnaires (3.41%). Among the collected surveys, one response was not valid, and therefore only 26% of the total population responded, which can be considered representative.

### 3.3. Data Analysis

The Spearman Correlation Rank method was used for the data analysis in order to find correlations between discrepancies evidenced in the exporter’s survey with selected controlled numerical variables. Descriptive statistics collected, including the variables not controllable by exporters was also used to provide explanations of the correlation analysis results (see Chapter 4).

The Spearman Correlation Rank Coefficient is known as non-parametric rank statistics used for measuring the correlation between variables with a ranking order (Conover & Iman 1981, 128). It can be said that the Spearman Rank Correlation Coefficient is similar to Pearson’s Correlation Coefficient used when the data are also in a ranked format (similar to the current research, as the data were collected on a Likert scale from 0 to 100% occurrence of the phenomenon). The data were analysed using the SPSS Statistics 24 software package. Statistical significance of the results was estimated at the 95% confidence level. Table 2 provides a summary of the correlation analysis results. Further details regarding the results of correlation analysis between the controllable variables and variables describing documentary discrepancy are presented in publications I and II.
Table 2: Correlation between the controlled variables and the variables describing documentary discrepancies

<table>
<thead>
<tr>
<th>Type of discrepancy</th>
<th>Size of export to total sale</th>
<th>INCOTERMS 2010</th>
<th>Third party issued documents</th>
<th>Knowledge, skills, training and experience of employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bill of exchange</td>
<td></td>
<td>CIP (-0.420)</td>
<td></td>
<td>Prior experience with DLC (+0.412)</td>
</tr>
<tr>
<td>Commercial invoice</td>
<td>+ 0.563</td>
<td></td>
<td>Bill of lading (+0.499), NNSW (+0.372)</td>
<td></td>
</tr>
<tr>
<td>Packing list</td>
<td></td>
<td>CFR (+0.637), DAT (+0.373), FCA (+0.484)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transport document</td>
<td></td>
<td>FCA (+0.444), CFR (+0.395), CIF (+0.460)</td>
<td></td>
<td>Understanding DLC process (-0.51), prior experience with DLC (-0.308)</td>
</tr>
<tr>
<td>Insurance document</td>
<td></td>
<td>CIF (+0.359)</td>
<td>NNSW (-0.350)</td>
<td></td>
</tr>
<tr>
<td>Inspection certificate</td>
<td></td>
<td>FCA (+0.441)</td>
<td>Incorrect shipment (-0.466)</td>
<td></td>
</tr>
<tr>
<td>Certificate of origin</td>
<td></td>
<td>FCA (+0.376), CPT (+0.467), CIP (+0.460), DAP (+0.384), DAT (+0.420)</td>
<td>Inspection certificate (+0.347)</td>
<td>Prior experience with DLC (-0.140), special training in the relevant area (+0.401)</td>
</tr>
<tr>
<td>Government certificate</td>
<td></td>
<td>CPT (+0.370), CIP (+0.371), CIF (+0.361)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Late presentation</td>
<td></td>
<td>FCA (+0.368), DDP (-0.370)</td>
<td>Government certificate (+0.363)</td>
<td>Understanding DLC process (-0.308), prior trading history (-0.380), relationship with presenting bank (+0.381)</td>
</tr>
<tr>
<td>Missing document</td>
<td></td>
<td>CIF (+0.361), DAP (+0.410), DDP (+0.370)</td>
<td></td>
<td>Detailed knowledge of UCP 600 (-0.345)</td>
</tr>
<tr>
<td>Incorrect or partial shipment</td>
<td></td>
<td>DAT (+0.370)</td>
<td>Inspection certificate (-0.466)</td>
<td></td>
</tr>
</tbody>
</table>
3.4. Conclusions

To answer RQ 3 (Why do documentary discrepancies occur in practice in Estonian exports using DLC operations?), an empirical study was conducted among Estonian exporting companies backed by semi-structured interviews with trade finance officers in Estonian banks providing export DLC services. The scope of the study was wider than just answering RQ3, and also involved mapping the Estonian export trade landscape through collecting descriptive statistics from the Estonian exporting companies using DLCs. The chapter provides some details of the research design, data acquisition and correlation analysis conducted. Although this analysis does not reveal cause and effect relationships between the controllable variables and variables describing documentary discrepancies in DLC operations, it provides some insight into the complicated interplay of the different factors involved, which will be analysed in the next chapter.
4. THE RESULTS OF EMPIRICAL SURVEY

In the north-east of the Baltic Sea, Estonia with Latvia and Lithuania form the three Baltic States. Its exports were estimated at around 13.4 billion USD in 2015 including electronics, automatized machinery, wood, scrap metal and fabricated buildings (www.oecd.org). Within the same period, its main imports amounted to 15.3 billion USD including: cars, electronics, and refined petroleum (www.oecd.org). The negative trade balance of 1.9 billion USD is a good motivation for Estonian authorities to promote export trade by different means (Estonian Chamber of Commerce and Industries, 2016). However, to overcome the existing negative trade balance, Estonia faces challenges like: lack of access to sufficient human and financial resources, limited number of industries active in export business, small size of exporting companies and limited number of banks active in the field of international trade finance (Estonian Chamber of Commerce and Industries, 2016).

4.1. Estonian Export Landscape

According to the European Union’s method for categorizing companies (European Union Recommendation 2003/61/EC), Estonian export trade consists of micro, small, medium and large enterprises. The research further distinguishes these exporting firms based on their experience in export trade by dividing them into two main groups – new exporters (less than five years of experience in export trade) and established exporters (more than five years of experience in export trade).

From the perspective of industries active in Estonian export trade, official resources like Trade with Estonia (2017), report the involvement of seven main industries including: food and equipment, chemicals and health, building and construction, machinery and automatized systems, forestry and mining, and last but not the least, information technology.

The structure of the exporting community in Estonia is dominated by micro and small firms representing 87% of total participants in the survey. The most common trade term used by them is Cost Insurance and Freight (CIF), and Free on Board (FOB), which is understandable due to the strong sea freight in Estonia. Almost all exporters use the services of freight forwarders. Therefore, third-party documents prevail in the Estonian export environment. Most of the documents are produced using computers and the exporters used their own bank as well as other banks, which have been defined as the advising bank according to the credit, which is reasonable, as there are only four banks in Estonia active in the field of trade finance.

1 www.tradewithestonia.com [accessed 1.2.2018]
Managing customer risk is ranked highest among the reasons for using DLCs in Estonian export business. It is considered by 55% of respondents as the reason for using DLCs. The exporters use several relevant methods to mitigate customer risk and prevent bad debts, including: use of confirmed credit, silent confirmation, and export credit insurance. Interestingly, the study results show that the use of DLCs does not eliminate bad debt but reduces it substantially.

Country risk is also considered by Estonian exporters and banks as an important reason for the application of DLCs as a method of payment. Unfortunately, there is no access to the details of the export destinations of Estonian companies using DLCs as a method of payment. However, it is possible to conclude that the use of the confirmed DLC on its own is a reason for the existence of a general bank risk. Although at a very low rate, it was visible from the results of the survey that technical risk (subject to different interpretations by the banks) exists in practice and the use of confirmation is one way to hedge it.

Erroneous documents are a common type of risk that can occur in different parts of the export process. However, their effect on the documentary production process is significant as it may result in dishonouring the presentation by the bank. The data indicate that within the framework of the Estonian export landscape, the majority of the errors appear in internally produced documents. This finding is also relevant for other elements of the model: behavioural risks and human errors. The data collected indicate that omissions like missing data on documents or stipulated documents per se may also result in errors.

The Sight Letter of Credit is used in most cases. However, the use of acceptance credit with extended terms of payment is also common. The majority of DLC users prefer confirmation of the credit.

The majority (82%) of the respondents face discrepancies in their DLC transactions. Interestingly, most of the discrepancies are related to documents produced by the exporter internally. It is difficult to identify any single type of discrepancy due to the limited data set. However, different elements like the lack of internal standard procedures or the absence of mechanisms to enforce them in the company as well as human errors can be considered.

The cost of rectifying the documents can vary. The rectification of each document may cost up to 900 euros and each presentation may have numerous discrepant documents. When there is no possibility to rectify the documents, the exporter may choose one of the following options: overlooking the minor discrepancies and effectuating the payment by the bank, the bank may pay with recourse, depending on the acceptance of the discrepancies by the issuing bank or the buyer may waive the documentary discrepancies.

2 The Sight Letter of Credit is a type of DLC in which the bank pays immediately after verifying the compliance of the presentation.
There was no clear answer to the issue of bad debts. However, the bank officers considered this to be very low and the survey of exporters also indicated it was not significant.

The majority of the exporters do not face exchange risk as they only use euros in their export transactions. However, in cases with exposure to foreign exchange risk, most of the firms do not have any measures to mitigate that risk.

The survey also shows that exporting firms consider three attributes of the DLC as most important:

- proper understanding of the DLC process;
- prior experience with DLC transactions;
- relationship between the seller and the buyer.

More than 50% of the employees in exporting companies have not received any training or just a small portion of them have had the opportunity for training. There were no comments on the availability of in-service training for the document preparation staff.

All respondents confirmed the use of discounting practices. The bank officers also commented on the popularity of discounting practices in Estonia. The results of the survey do not depend on company size or expertise in export trade.

4.2. Documentary Discrepancies in the DLC Operations

The interpretation of the results presented in Table 2 provides us with a picture of the extent to which the selected controllable factors affect discrepancies in different documents and can be used to suggest the means for managing the discrepancy rate.

The ratio of exports to total sales shows a positive significant correlation with the discrepancy in commercial invoices. The outcome of this is in accordance with the principles of ERM, as increasing the exposure to a particular risk will increase the possibility for its occurrence.

The analysis of the correlation between third-party issued documents and different types of discrepancies shows a positive correlation between the use of bills of lading and the discrepancy in commercial invoices, and a negative correlation with the certificate of origin. The positive correlation can be explained based on the principle of strict compliance, which requires compliance in the data available in each document with the terms of credit as well as the consistency of the data across different documents. Therefore, inconsistency between the data in the commercial invoice and the bill of lading can result in the bank dishonouring the presentation due to the discrepancy in the commercial invoice. The reason for the negative
correlation with the discrepancy in the certificate of origin is not known and this could be a topic for further research.

The Non-Negotiable Sea Waybill (NNSW) shows a positive correlation with the discrepancies in the commercial invoice while indicating a negative correlation with the discrepancies in the insurance document and the certificate of origin. Again, a similar line of reasoning can be used to explain the positive and negative correlations. The Air Waybill (AW) and Government Certificate (GS) are the least used third party issued documents. Among them, the use of AW does not show any correlation with the discrepancy in different documents, but the use of GS shows a positive correlation with Late Presentation. This can be explained as getting stock in the official procedure for issuing the certificate may result in Late Presentation after the expiry of the credit. The Certificate of Origin shows a positive correlation with the Inspection Certificate, while the Inspection Certificate shows a negative correlation with incorrect or partial shipments. The reason is not known and could be an element for further research.

No significant correlation was found between the use of EXW (Ex-Work) and discrepancies in any of the surveyed documents. This indicates that adherence to the minimum documentary obligations will reduce the level of discrepancy. CIF as the most frequently used INCOTERM by Estonian exporters shows a positive correlation with discrepancies in Transport Documents, Insurance Documents, Government Certificates and Missing Deliveries. Interestingly, FOB (Free on Board) does not show any correlation with the occurrence of documentary discrepancies. The lack of an insurance document and the responsibility for arranging the vessel by the buyer can clearly explain the lack of correlation with the relevant document.

Carriage and Insurance Paid (CIP) is the equivalent of CIF in multi-mode transport, and using it has a positive correlation with discrepancies in the insurance document, the certificate of origin and the government certificate. This is a meaningful outcome as the relevant documents are all external documents and none of them is produced under the control of an exporter. However, the use of CIP shows a negative correlation with the discrepancies in the bill of exchange. The Carriage Paid To shows a positive correlation with discrepancies in the Government Certificate and the Certificate of Origin. The Free Carrier shows a positive correlation with discrepancies in the Packing List, the Transport Document and Late Presentations. The Cost and Freight which indicates the payment of shipping freight by the exporter also shows a positive correlation with the Transport Document and the Packing List.

Delivery at Terminal, Delivery at Place and Delivery Duty Paid are terms which show the highest risk for the exporter, as it will pass from him to the buyer after passing through the customs of the importer’s country. Accordingly, the use of delivery terms from this group has a positive correlation with Missing Deliveries, Late Personation, and Incorrect or Partial Shipment. In addition, the Delivery
at Terminal shows a positive correlation with discrepancies in the Packing List. However, due to nominal use of these terms by Estonian exporters, the importance of discrepancies resulting from their use in international DLC transactions is under question.

The study of the correlation between types of documentary discrepancy and the attributes of the DLC defined by Estonian exporters will help find ways to reduce the occurrence of such problems. Detailed knowledge of the UCP 600 shows a negative correlation with Missing Documents. This result is in accordance with the findings of the survey, as detailed knowledge of the UCP 600 was not considered an important attribute of the credit by the exporters.

In contrast, Understanding the DLC Process was ranked as the most important variable of the DLC transaction by the respondents and shows a negative correlation with the Discrepancy in Transport Document and Late Presentations. This shows the importance of this variable in reducing the Transport Document’s discrepancy as one of the third-party issued documents not under the exporter’s control. Furthermore, reducing the rate of late presentations after the expiry of the credit, results in the bank dishonouring the presentation.

Prior Experience with DLC transactions as another important variable of DLC shows a positive correlation with discrepancies in the bill of exchange and a negative correlation with discrepancies in the Transport Document as well as the Certificate of Origin. This result can be explained as an increase in the number of DLCs used in the export business will increase the exposure of Estonian exporters with the risk of discrepancies, and this is visible in the positive correlation of discrepancies in the bill of lading. However, Prior Experience with DLC Operations shows a negative correlation with discrepancies in the Transport Document and the Certificate of Origin. As both documents are issued by third parties, the result indicates that gaining experience in DLC operations will help exporters in reducing the discrepancies in the externally issued documents by providing the third-party issuers with proper instructions. This is in accordance with the survey findings as the number of discrepancies in externally produced documents are less than in internally issued documents.

The relationship between the seller and the buyer as another important variable of the DLC operation does not show a significant correlation with the discrepancies in any document. This result can be explained with the practical custom in international trade where the majority of discrepancies are waived by the buyer. The Country of Export, Supply and Demand Market Forces, and Common Industry Practices, as attributes of low importance in DLC operations, do not show any significant correlation with documentary discrepancies in internally or externally produced documents. Formal Training in the area of DLC operations shows a positive correlation with discrepancies in the Certificate of Origin. The reason is not known, but it could be related to the external nature of the certificate, as it is not produced
under the supervision of the documentary staff in the exporter’s organisation. Prior Trading History and Relations with Bank show a negative correlation with Late Presentation. This is in accordance with the findings of the survey, as the trade experience and relieving consultation from the bank results in the rejection of the presentation due to the exporter missing the credit’s expiry date.

The abovementioned findings show the importance of proper communication between involved parties and the clarity of instructions issued by the beneficiary to the third party issuing the documents, the choice of proper delivery terms and sufficient training of documentary staff within the structure of the exporting firm as the main factors that could reduce documentary discrepancies and consequent financial losses for the Exporter.

The findings of this research show that:
1) There is a significant correlation between increasing the volume of exports and exposure to documentary discrepancies in DLC transactions.
2) Another reason for documentary discrepancies in DLC operations in Estonia is the limited familiarity of the documentary employees in exporting companies with the relevant international practice.
3) Application of various delivery terms is another reason for the occurrence of documentary discrepancies. Different INCOTERMS require various types of documents.3
4) The need to present third-party issued documents is another reason for the occurrence of documentary discrepancies in Estonian export DLC transactions. Although, the third party will issue the required documents based on instructions received from the exporter, the exporting company does not have any control over the process of issuing third-party documents.

4.3. Recommendations

The analysis conducted makes it possible to answer RQ4: What measures should be taken by Estonian exporters to reduce the risk of documentary discrepancy in export DLC operations?
1) Checking the export to total sales ratio can be the foremost recommendation for Estonian exporting companies. The micro and small companies dominating the Estonian export landscape have relatively weak financial standing in contrast to their high appetite for business development oversees. Being tempted by the high profits from trading internationally and getting trapped in large export orders financed by DLCs without access to sufficient financial and human resources can result in significant losses (due to documentary discrepancies) and/or even the discontinuation of their business. They will not be easily able to absorb bad debts and delays in

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3 While C and D groups need to present the highest number of accompanying documents, E and F groups need significantly less complying documents in a complying presentation.
payment resulting from documentary discrepancies in DLC transactions.

2) The documentary staff of Estonian export companies need systematic in-service training in the specificities of international DLC transactions as well as international delivery terms, but the results of the exporter survey and interviews with bankers show the importance of these competences in preventing documentary discrepancies and the smooth operation of export DLCs in Estonia. This is particularly important as INCOTERMS and the UCP are subject to periodical revisions.

3) Establishing a rapport with the presentee bank and the third-party document issuing bodies is the next recommendation. Constant and strong business relations with the bank and the third-party service providers, such as freight forwarders, customs brokers and transport companies would help a lot in distinguishing and preventing discrepancies before losses occur.

4) It is of crucial importance to establish trusting relations with customers oversees, as they are the ones who can waive discrepancies even when a bank rejects the documents. Although the essence of using DLCs in international trade links business partners with no or limited knowledge of each other, another important feature of using this device is mitigating the risk to payments when the contract amount is significantly higher than the customer’s credit standing. In the case of a high number of transactions, a single documentary discrepancy can jeopardize the solvency of micro or small exporting companies. Therefore, establishing a rapport with the customer can be crucial as waiving a discrepancy can simply mitigate any risk of delays in payment or bad debts.

5) The empirical study showed that Estonian exporting companies do not have a clear understanding about the role and importance of a proper ERM system in mitigating different types of risk. However, they use elements of a systematic approach in managing their risk of documentary discrepancy in a non-harmonised and intuitive manner. Therefore, it is necessary for exporting companies in Estonia who choose to use DLC as a method of payment to make themselves familiar with the principles of ERM and take an informed holistic and systematic approach in managing the risk of documentary discrepancy and reduce potential losses resulting from dishonouring the presentation by the bank.
5. CONCLUSION

This research studies the application of ERM system associated with export DLC operations. Solving the research problem: **How to manage (reduce) the exporter’s risk of documentary discrepancy in DLC operations in Estonia** the following main results have been obtained:

1. The ELCBRM model proposed by Bergami has been further developed into an expanded ELCBRM model by amending Bergami’s model in two respects:
   - It has been demonstrated that fraud as an element of Bergami’s model is irrelevant in the context of export DLCs and needs to be removed from the ELCBRM model;
   - The ELCBRM model has been operationalised, attaching variables to different types of risk. This model can be used for partially quantitative empirical studies of risks associated with DLC operations in different contexts.

2. An empirical study was conducted to validate the applicability of the Expanded ELCBRM model in the context of the Estonian export landscape. For this purpose, correlations between the selected group of variables controllable by the exporter and different types of documentary discrepancy have been measured to reveal the relationships between the documentary discrepancy in DLC operations and the factors controllable by the exporters so as to find ways to mitigate the related risks.

3. The results of the empirical research indicate the high rate of documentary discrepancy among Estonian exporting firms using the DLC as a method of payment in their trade overseas. Consequently, the vulnerability of Estonian exporting firms to losses resulting from documentary discrepancies occurring in their DLC operations has been identified.

4. The research underlines the importance of:
   - increasing the awareness of Estonian international traders of the risks associated with export DLC operations;
   - developing an efficient ERM system for the reduction of the risks associated with DLC operations in Estonian exporting companies.

5. The successful application of the Expanded ELCBRM model to study the use of DLCs in Estonian export trade operations shows that the model can also be used to describe and analyse the use of DLCs in export trade and to design measures to improve the ERM system in different contexts.

An answer to RQ1 has been provided in publications V, VI and VII (see Table 3). The legal nature of DLCs, the principle of strict compliance and the different risks involved in DLC operations have been deeply analysed to provide a rigorous answer to the question: What is a compliant presentation in the law covering international DLC operations? Publication III provides an answer to RQ2 by analysing different existing ERM models and their applicability to DLC operations. Publication
IV indicates the contradictory nature of including fraud as a source of risk for documentary discrepancies in DLC operations. As a result, it is recommended to exclude fraud from the ELCBRM model.

Publications I and II analyse the major types of risk associated with DLC operations and answer RQ3 by measuring the correlation between the variables controllable by the exporter and the variables associated with documentary discrepancies in Estonian exporting companies using DLCs.

Finally, RQ4 was answered by providing recommendations to Estonian exporting companies using DLCs as a method of financing their trade. In order to reduce the discrepancy rate and reduce losses in Estonian exporting companies, the author has recommended:

• more efficient procedures for documentary production and checking the correctness of documents;
• proper communication with the external parties involved in the production of third-party documents stipulated in the credit;
• regular in-service training of employees involved in producing documents for DLC operations.

Table 3: Contributions of the Author’s publications

<table>
<thead>
<tr>
<th>No</th>
<th>Research question</th>
<th>Research method</th>
<th>Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>How to apply the Expanded ELCBRM model in the Estonian export landscape?</td>
<td>Correlation analysis</td>
<td>Defining the correlation between selected controllable variables and different types of documentary discrepancy</td>
</tr>
<tr>
<td>II</td>
<td>How to Apply the Expanded ELCBRM model in the Estonian export landscape?</td>
<td>Correlation analysis</td>
<td>Defining the correlation between selected controllable variables and different types of documentary discrepancy</td>
</tr>
<tr>
<td>III</td>
<td>What is the current situation of risk management, ERM system development and their applicability in DLC operations?</td>
<td>Comparative study of ERM methods</td>
<td>Analysis of different ERM methods and their applicability to DLC operation</td>
</tr>
<tr>
<td>IV</td>
<td>What is the legal nature of fraud in DLC operations and different international laws?</td>
<td>Doctrinal and comparative analysis</td>
<td>Analysing the legal nature of fraud in DLC operations and different international legal frameworks</td>
</tr>
</tbody>
</table>
V What are the risks associated with DLC operations?

<table>
<thead>
<tr>
<th>No</th>
<th>Research question</th>
<th>Research method</th>
<th>Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>V</td>
<td>What are the risks associated with DLC operations?</td>
<td>Comparative legal case analysis</td>
<td>Identification of existing risks for each involved player in DLC operation.</td>
</tr>
<tr>
<td>VI</td>
<td>What is the legal nature of the DLC operation?</td>
<td>Doctrinal</td>
<td>Defining the Legal Nature of the DLCs in International Trade</td>
</tr>
<tr>
<td>VII</td>
<td>What is the legal nature of the compliant presentation?</td>
<td>Doctrinal and Comparative Analysis</td>
<td>Analysing different types of discrepancies and the legal nature of compliant presentation from legal perspective</td>
</tr>
</tbody>
</table>

The problems of risk management in international trade finance are far too complicated to be tackled in a single doctoral thesis. Therefore, many aspects of ERM for companies using DLCs as a method of payment are out of the scope of this thesis. However, esteemed researchers may consider application of the Expanded ELCRB model developed by the Author in other countries for studying the reasons of documentary discrepancies in the DLC operations and designing the measures for reducing this risk.
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49


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## APPENDIX 1: TYPES OF VARIABLES AND THEIR RANGE

<table>
<thead>
<tr>
<th>Type of Risk</th>
<th>Variable</th>
<th>Type of Variable</th>
<th>Range of Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental Risk</td>
<td>Company size</td>
<td>Ordinal</td>
<td>Natural Numbers</td>
</tr>
<tr>
<td></td>
<td>Years of export experience</td>
<td>Ordinal</td>
<td>Natural Numbers</td>
</tr>
<tr>
<td></td>
<td>Number of transactions</td>
<td>Ordinal</td>
<td>Natural Numbers</td>
</tr>
<tr>
<td></td>
<td>Type of industry</td>
<td>Nominal</td>
<td>Food and Food Industry Equipment’s Chemical and Health Care Building and Construction Machinery IT Others</td>
</tr>
<tr>
<td></td>
<td>Choice of bank</td>
<td>Nominal</td>
<td>Own Bank Advising Bank Any Bank</td>
</tr>
<tr>
<td></td>
<td>Use of credit agencies and mercantile agencies</td>
<td>Dichotomous</td>
<td>Yes No</td>
</tr>
<tr>
<td></td>
<td>Method used for assessing the country risk</td>
<td>Nominal</td>
<td>Checklist approach Delphi technique Quantitative analysis Inspection visits Combination techniques</td>
</tr>
<tr>
<td></td>
<td>Reason for choosing the LC as payment method by Estonian exporting firms</td>
<td>Nominal</td>
<td>Importing country regulations- Unacceptable country risk Unacceptable customer risk Value of export sales Other</td>
</tr>
<tr>
<td></td>
<td>Type of DLC</td>
<td>Nominal</td>
<td>Standard Irrevocable letter of Credit Red Clause Letter of Credit Transferable Letter of Credit Back to Back Letter of Credit Revolving Letter of Credit Other</td>
</tr>
<tr>
<td></td>
<td>Maturity date of payment</td>
<td>Ordinal</td>
<td>Sight Payment (0 days), 1-30 days, 61-90 days, 91-120 days, 121-150 days, 151-180 days</td>
</tr>
<tr>
<td></td>
<td>Number of confirmed letters of credit used</td>
<td>Ordinal</td>
<td>Natural numbers</td>
</tr>
<tr>
<td></td>
<td>Bad debts resulted from discrepancy in DLC</td>
<td>Dichotomous</td>
<td>Yes No</td>
</tr>
<tr>
<td></td>
<td>Number of discounting practice for exporting firms</td>
<td>Ordinal</td>
<td>Natural numbers</td>
</tr>
<tr>
<td></td>
<td>Possible reasons for using discounting practice for exporting firms</td>
<td>Nominal</td>
<td>Defined by respondents</td>
</tr>
<tr>
<td></td>
<td>Country Risk</td>
<td>Nominal</td>
<td>Free text</td>
</tr>
<tr>
<td>Behavioural Risk</td>
<td>Required skills for the international DLC transaction</td>
<td>Nominal</td>
<td>Free text</td>
</tr>
<tr>
<td>-----------------</td>
<td>------------------------------------------------------</td>
<td>---------</td>
<td>------------</td>
</tr>
<tr>
<td>Number of years of experience for employees</td>
<td>Ordinal</td>
<td>0-1 year, 2-3 years, 4-5 years, more than five years</td>
<td></td>
</tr>
<tr>
<td>Special training on documentary letters of credit for staff.</td>
<td>Dichotomous</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Process Risk</td>
<td>Choice of delivery term</td>
<td>Nominal</td>
<td>INCOTERMS 2010¹</td>
</tr>
<tr>
<td>Required skills for the international DLC transaction</td>
<td>Nominal</td>
<td>Defined by respondents</td>
<td></td>
</tr>
<tr>
<td>Number of export documentation employees</td>
<td>Ordinal</td>
<td>Natural numbers</td>
<td></td>
</tr>
<tr>
<td>Mode of transport</td>
<td>Nominal</td>
<td>Air, Land, Sea, Multimodal</td>
<td></td>
</tr>
<tr>
<td>Use of freight forwarders services during the export process</td>
<td>Dichotomous</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Necessity for issuing documents by third party organizations</td>
<td>Dichotomous</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Type of discrepancy</td>
<td>Nominal</td>
<td>Errors in the bill of exchange, Errors in the commercial invoice, Errors in the packing list, Errors in the transport document, Errors in the inspection certificate, Errors in the certificate of origin, Errors in the government certification, Late shipment, Missed consignment in predetermined delivery schedule, Documents presented after LC’s expiry, Missing documents, Incorrect or partial shipment, Other</td>
<td></td>
</tr>
<tr>
<td>Frequency of documentary rejection by bank</td>
<td>Ordinal</td>
<td>Natural numbers</td>
<td></td>
</tr>
<tr>
<td>Corrective action of choice by exporting firm</td>
<td>Nominal</td>
<td>Local bank will argue on behalf of exporter with issuing bank, Local bank refers matter to exporting company without further involvement, Exporting firm will start direct negotiations with applicant to receive waiver, Other</td>
<td></td>
</tr>
<tr>
<td>Proportion of waiver of discrepancies given by buyer</td>
<td>Ordinal</td>
<td>0-25%, 26-50%, 51-75%, 76-100%</td>
<td></td>
</tr>
<tr>
<td>Relevant costs to rectify discrepancies</td>
<td>Ordinal</td>
<td>Natural numbers</td>
<td></td>
</tr>
</tbody>
</table>

¹ INCOTERMS are explained in Data Analysis section
APPENDIX 2: EXPORTERS SURVEY QUESTIONNAIRE

Section 1. Business Environment and General Information
1) Does your firm export Estonian Origin goods to the EU and Non-EU countries?
   • Yes
   • No. If no, please return the survey without completing it.
2) How many employees do you have in your firm?
   .................. number of employees
3) How many employees are directly involved in export documentation functions?
   ................. number of employees
4) What is the percentage of employees involved in export documentation functions having received specific training on export DLCs?
   • 0-25%
   • 26-50%
   • 51-75%
   • 76-100%
5) On average, how long is your export documentation employees experience in dealing with DLCs?
   • 0-1 Years
   • 2-3 Years
   • 4-5 Years
   • More than five years
6) Please indicate industry sector(s) of your export inside and outside the EU
   ........................................................................................................................................................................
   ........................................................................................................................................................................
   ........................................................................................................................................................................
7) How long is your company’s experience in exporting from Estonia?
   ................. years
8) What was the total export sales value of your company in fiscal year of 2014-15?
   • Less than 1 million euros
   • 1-5 million euros
   • 5-10 million euros
   • Over 10 million euros
9) What was the approximate percentage of export sales to total sales in fiscal year of 2014-15?
   • 0-25%
   • 26-50%
   • 51-75%
   • 76-100%

10) What is the approximate level of export against methods of payment below?
   • Prepayment .........................%
   • Bill of Exchange ......................%
   • Letter of Credit......................%
   • Open account .........................%
   • Other Methods (please indicate) .....%

11) What are the credit terms used by your company for export DLCs?
    Values expressed in percentage (%) 0-25 26-50 51-75 76-100
    Sight Letter of Credit
    Acceptance Letter of Credit:
    1-30 Days
    61-90 Days
    91-120 Days
    121-150 Days
    151-180 Days

12) What types of export DLC are used by your company? (Please estimate the percentage on the basis of 2014-15 fiscal year)
    Values expressed in percentage (%) 0-25 26-50 51-75 76-100
    Standard Irrevocable Letter of Credit
    Red Clause Letter of Credit
    Transferable Letter of Credit
    Back to Back Letter of Credit
    Revolving Letter of Credit Other. Please indicate

13) What was the approximate number of export DLC transactions used by your company in fiscal year of 2014-15?
    ....................... number

Section 2. Risks of Export Trading

14) Please indicate methods which are used by your company in defining the country risk in export business:
   • Checklist Approach
   • Delphi technique
   • Quantitative Analysis
   • Inspection visits
   • Combination techniques
   • Estonian Trade Promotion Services
15) Why the DLC is chosen as a method of payment in the export process?
   • Importing Country Regulations
   • Unacceptable country risk
   • Unacceptable customer risk
   • Value of export sales
   • Other, please specify ………………

16) In case of non-obligatory choice, who decides on export DLC as a method
    of payment in the export process?
   • Sales
   • Marketing
   • Finance
   • Combination
   • Other, please specify ……

17) Does your company use any services from credit agency in the process of
    country risk /customer risk assessment?
   • Yes, please specify
   • No

18) Does your company utilise the services of credit insurance agency in the
    export process?
   • Yes, please specify
   • No

19) Does your company use the confirmed DLC in the export process?
   • Please indicate the approximate value in fiscal year of 2014/15
   • No

20) Does your company use “Silent Confirmation” in DLC operation in the
    export process?
   • Please indicate the approximate value in fiscal year of 2014/15
   • No

21) What is the major currency used by your company in export letter of credit
    transaction?
   • Euro
   • Other, please specify

22) While using foreign currency in the export DLC transaction, which
    mechanisms are used by your company to reduce exposure to exchange risk?
   • Entering into forward exchange contract to all foreign exchange transactions
   • Entering into forward exchange contract only in cases that transaction value
     is above equivalent of …… euros (please indicate the amount)
   • Finance department is responsible for firm’s exchange risk exposure
• Foreign exchange risk exposure is managed directly by the company’s bank
• There is not specific exchange risk management strategy in place
• Other, please specify
• ……………………………………………………………………………

Section 3. Letter of Credit Operation

23) Please rank the following attributes in the preparation process of export DLC documents:
• Detailed knowledge of UCP 600
• Understanding of Letter of Credit process
• Prior experience in letter of credit transactions
• Formal education in relevant area
• The relationship between beneficiary and applicant
• The country of export
• Prior trading history
• The supply demand market forces
• The relationship with presenting bank
• Common industry practices

24) How do you receive export DLCs?
Through your bank Always Sometimes Never
Through another bank Always Sometimes Never

25) Which Incoterm 2010 is used by your company in the export trade (please indicate its approximate percentage in fiscal year of 2014/15)?
Values are expressed in percentage (%) 0-25 26-50 51-75 76-100
• EXW Ex-Work
• FCA Free Carrier
• CPT Carriage Paid To
• CIP Carriage and Insurance Paid To
• FAS Free Alongside Ship
• FOB Free on Board
• CFR Cost and Freight
• CIF Cost, Insurance and Freight
• DAT Delivered at Terminal
• DAP Delivered at Place
• DDP Delivered Duty Paid

26) Does your company operate with cargo insurance cover on an open policy basis enabling certificates of insurance to be issued in-house?
• Yes, please indicate the name of insurance company
• No

27) How often do export DLC require the presentation of third party documents?
Values are expressed in percentage % 0-25 26-50 51-75 76-100
• Bill of lading
• Non-negotiable Sea Waybill
• Air Waybill
• Certificate of Origin
• Inspection Certificate
• Government Certificate
• Other
• Other
• Other
• Other

28) Does your company use the services of freight forwarders in export process?
   • Yes, please indicate the name
   • No

29) How do export consignments leave your warehouse?
   Values expressed in percentage % 0-25  26-50  51-75  76-100
   • Delivered directly to carriers
   • Delivered directly to freight forwarders
   • Collected by freight forwarders
   • Others, please specify

30) What is the mode of transport used for export process?
   Values are expressed in percentage % 0-25  26-50  51-75  76-100
   • Air
   • Sea
   • Post
   • Combined transport (Multimodal)

31) How does your company instruct external document procedures in relation to the required data contents on DLC documentation in the export process?
   • Paper based instructions on service providers letterhead
   • Electronic instructions

32) Who prepares your documents against export letter of credit transaction?
   Please do not consider documents that are issued by third parties.
   • Internally prepared by employees by:
   • Specific document personal
   • General Administration Staff
   • Outsourced under the contract to a service provider. Please describe the arrangements for outsourcing

33) What method do you use for preparation of export DLC documents?
   • Manually prepared documents
   • Computer generated documents
• Internally designed programmes
• Commercial software

34) In case of using an Electronic Systems, are such electronic systems integrated with other internal information processing systems?
• Yes
• No
• Not applicable

35) Are these electronic systems integrated with external systems (like bank processing systems)?
• Yes
• No
• Other methods

36) To which bank does your company present export DLC documents?
• Own bank only
• Advising bank
• Any bank

37) Who makes the decision on choice of bank which receives the export DLC documents?
• Company policy
• Documentation staff
• Sales and marketing staff
• Finance staff
• Other, please indicate …..

38) Does your company consult with the relevant local bank before lodging documents against export DLC?
• Yes, please indicate percentage of transactions …… %
• No

39) What is the approximate number of days after lodgement of export DLC documents you receive notification from the bank about acceptance/rejection of your documents?
…………………………… days

40) Has your export DLC lodged by your company been ever rejected?
• Yes
• No

41) In percentage terms, what is your company’s documentary rejection rate against export DLC export from Estonia?
…… %
42) In case of documentary rejection according to question 40, which actions will take place:
Values are expressed in percentage % 0-25  26-50  51-75  76-100
• Local bank will argue on your behalf with The issuing bank
• Local bank refers matter to your company without further involvement
• Your company will start direct negotiations with the Applicant to receive waiver
• Other, please indicate ………………………..

43) What are your documentary discrepancies in the export DLC operations from Estonia?
Please choose the applicable cases.
Values are explained in percentage % 0-25  26-50  51-75  76-100
• Errors in the bill of exchange
• Errors in the commercial invoice
• Errors in the packing list
• Errors in the transport document
• Errors in the inspection certificate
• Errors in the certificate of origin
• Errors in the government certification
• Late shipment
• Missed consignment in predetermined
• Delivery schedule
• Documents presented after LC’s expiry
• Missing documents
• Incorrect or partial shipment
• Other factors, please indicate ………

44) Have you ever faced with the occasion that local (advising bank) accepts your presented documents as compliant but the issuing bank later rejects them due to incompliance with the DLC terms?
• Yes, please indicate the percentage ……… %
• No

45) Does your company follow any standard procedure in preparation and lodgement of documents under the export DLC practice from Estonia?
• Yes
  - Standard Operation procedures
  - Department /Company Policy
  - Other, please indicate ………………………..
• No
46) In case of documentary discrepancy under the export DLC transactions from Estonia, what is the percentage your company has succeeded to resubmit compliant documents in the fiscal year of 2014/15?
• 0-25
• 26-50
• 51-75
• 76-100

47) In case of documentary discrepancy in the export DLC transactions from Estonia what are the expected results? Please indicate the frequency of an event.
Values are expressed in percentage % 0-25 26-50 51-75 76-100
• Importer gives waiver on discrepancy
• Importer looks for extended payment
• Importer asks for price reduction
• Other actions, please indicate

48) What percentage of bad debts has your company experienced in the export DLC transactions from Estonia?
………………………… %

49) What is your estimation about the cost of rectifying the documentary discrepancies in the export DLC transactions from Estonia in time and money terms?
…………………………. hours
…………………………… euros

50) Does your company practice discounting (selling the DLC to bank in return for advance payment)?
• Yes
  Please indicate the total number of discount operations in the fiscal year of 2014-15
  ……..
  Please indicate the total value of discount operations in the fiscal year of 2014-15
  ……..
• No

51) Why does your company follow the discount practice of DLC transactions from Estonia?
• Cash flow considerations
• Other reasons, please indicate ………………………
APPENDIX 3: INTERVIEW QUESTIONS FOR TRADE FINANCE OFFICERS IN BANKS

Section I: Export Information
1) Does your bank have any involvement in export DLC for goods with Estonian Origins?
2) Please indicate rough number of LCs which you issue per year and their type
3) Do your employees receive training before directly dealing with export documentation process?

Section II: Export Trading Risks
4) Please indicate how does your bank evaluate the country/customer risk for goods exported from Estonia?
5) Why does your customer choose the DLC as a payment method for export?
6) Does your bank use any credit insurance service?
7) How does your bank manage the exchange risk?

Section III: DLC Operation
8) As a trade finance officer in bank, please name and rank most important factors which play role in process of DLC documents preparation
9) How frequently does your bank deal with documents issued by third party and what are they?
10) What are the modes of document production uses by your customers (e.g. hand written, computer designed, …) and do your customers present documents stipulated in DLC and do they consult with you before presentation of documents?
11) What is the rejection rate of DLCs issued for your customers, due to discrepancy in which documents? Are rejected documents mostly prepared by your client or third party? And what is your course of action after issuing rejection note?
12) What will happen if the discrepancy is not possible to be rectified?
13) Do your customers practice discount and negotiation of DLC before maturity and why?
6. PUBLICATIONS
6.1. MITIGATING THE RISK OF DOCUMENTARY DISCREPANCY IN PROCESS OF ESTONIAN EXPORT LETTERS OF CREDIT TRANSACTION

Hamed Alavi

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Abstract

The main subject of this paper is to study relations between metrics which affects payment risk under documentary letters of credit (DLC) from the exporters perspective in Estonia. This will result in reducing the risk of documentary discrepancy in presentation of documents to banks, decrease relevant costs to rectification of discrepancies which are nothing but a loss to exporter and improving the flow of international trade. For this purpose, the author takes an empirical approach in his strive to find answer to following questions: What are different types of discrepancy in Estonian export landscape? How relevant are deferent attributes of the DLC to attributes types of discrepancy? What measures should be in place to prevent risk of documentary discrepancy in DLC operation? (In Estonian export trade).

Key Words: Documentary Letters of Credit, Process Management, Discrepancy, Attributes of DLC, Export, Estonia

Introduction

Regardless of being importer or exporter, the payment problem is one of the riskiest aspects of doing business with other countries. As a result, and in the course of time, the trader’s society has developed different types of payment method applicable to international business (Chuah, 2009). Such payment methods can be listed from the exporter’s perspective and from least risky to riskiest ones as following: Open Account, bill of exchange or Documentary Collection, Documentary Letters of Credit (DLC) and prepayment (Alavi, 2016a; Debattista, 2007).

Among all above mentioned methods, the DLC are known as the most favorable method of payment for initiating transaction between importer and exporter in different countries with no solid information about each other’s financial standing and trade background (Bergami, 2014). By shifting the payment risk from the importer to irrevocable promise of payment by the bank, the DLC will guarantee receiving of payment for shipped goods by the exporter under the condition that the payment will take place after presentation of hundred percent compliant documents stipulated in the credit by the exporter (Alavi 2016b). Apart from their application in international trade finance, documentary letters of credit are popular instruments used for the purpose of credit enhancement within the framework of international project finance and technology transfer projects (Hofmann, 2007; Alavi & Habec 2016).
The definition and types of discrepancy in the documents tendered as well as different options for the bank in response to discrepant tender by the exporter are regulated by the International Chamber of Commerce (ICC) under the Unified Custom and Practices for Documentary Letters of Credit (UCP). Currently, the UCP 600 is in force since 2007 (UCP600). The UCP 600 provides that documents presented under DLC operation should be in full compliance with terms and conditions of the credit otherwise bank is obliged to reject the presentation as a whole. (UCP600 article 15). According to the ICC, the world-wide documentary discrepancy rates against the DLC are between 60% to 70%. These figures appear to be consistent with studies in the USA citing discrepancy rates of 73% and the UK, with 50% to 60% (SITPRO Ltd, 2003). The cost of discrepancies is not well researched and, therefore, difficult to establish, but in a study by SITPRO Ltd it was estimated “that in 2000 the UK lost £ 113 million through non-compliant documents being presented under Letters of Credit” (SITPRO Ltd. 2003). Where discrepancies cannot be resolved, the result may be financial loss to the exporter as a result of the issuing bank rejecting the documents. This is a significant issue from the risk management point of view (Alavi 2016c).

In practice, the initial point for raising the problem of documentary discrepancy in the international DLC transaction is the lack of exporter’s control over production of all documents (Hwaidi, 2014). Some documents are produced internally by the exporter’s staff while some others are produced by the third parties (e.g. insurance, certificate of inspection and transport document) (Mehta, 1999). As a result, the application of a proper risk management programmer which covers internal and external sources of risk seems not only useful but also necessary in reducing the cost of discrepancy for the exporters (Bergami, 2011).

Estonia together with Latvia and Lithuania forms three Baltic States in the north east of the Baltic Sea. Its main export items amounting to 13.4 Billion USD in 2015 are electronics, wood, automotive, fabricated buildings, and scrap metal. (OECD website). At the same time, main imports of the country during the same period included: electronics, refined petroleum, cars and amounting for 15.3 Billion USD. The negative trade balance of 1.9 Billion USD is a good motivation for Estonian government to promote export business. In this regard different promotional activities of Estonian Chamber of Commerce and Industries including trade missions and export academy can be mentioned (KODA.ee, Estonian Chamber of Commerce and Industries). However, small size of the Estonian economy creates respective limitations on the way to form a high export profile. Among existing limits main ones can be mentioned as: small size of companies, lack of access to sufficient human and financial resources, limited number of banks active in international trade finance and limited number of industries active in export business.

The absence of empirical study to analyses the level of discrepancies and imposed losses resulting from it on Estonian exporting firms was the main idea behind the
choice of current research topic. Data on most occurred types of documentary discrepancy, reasons behind occurrence of them and application of suitable risk management model to mitigate such risks can help Estonian exporters to reduce their latent losses substantially.

In this paper, author uses the analogy of process management in export DLC transaction by finding answer the questions of: This paper is divided into six main parts: After introductory part, complex operation of documentary letters of credit would be explained, section three will discuss attributes of Estonian exporters and section four discusses the research design. Section five will study result of analyzing data collected from Estonian exporters. Final section is devoted to conclusions.

Research Design

The data have been collected by conducting exporters’ survey questioners. The exporters’ survey aimed at measuring the correlation between the variables describing documentary discrepancies, and two groups of variables controllable by the exporters (Level of export sales to total sales and Characteristics of DLC,). In total 1200 questionnaires were distributed in accordance to the data in the Estonian Export Directory (www.estonianexport.ee). Data collected from the interviews with bank officers show that in total 100 to 150 Estonian exporting companies use DLC as a method of payment in conducting their international transactions. At the end of September 2016, 41 responses were collected, which is 27.3 percent of the total population. As a result, the collected data are sufficient for this research, despite of comprising a small proportion of distributed questionnaires (3.41%). Among collected data one response was not valid, therefore, only 26% of the total population were responding which can be considered representative. Data analysis took place by using the Spearman Correlation Rank method. The data were analyzed using the SPSS Statistics 24. Statistical significance of the results was estimated on the 95% confidence level.

Results and Discussion

There is no global method for categorization of the firm’s size. Among existing methods based on their level of annual turnover, number of employees and other criterions, this paper follows the European Union method of categorization of firms based on the European Union Recommendation 2003/61/EC.

Accordingly, main criteria for categorization of firms is the annual turnover and /or number of employees (Lindner 2005). Number of employees is chosen as a criterion since it shows more relevance to main objectives of current study and proves itself as a more valid indicator in determination of size of exporting Estonian firms.
It is clearly visible that majority of respondents are among Micro firms. Taking the runner up position, Small Enterprises follow that micro firms with just a nominal difference. Increasing the size of the firm has strong impact of the number of exporting firms as medium enterprises show 30% drop in number by only 5 of exporting companies and there was no large respondent with more than 250 employees among respondents. (cf. Table 1).

Table 1: Firm Size in Estonian Export Market

<table>
<thead>
<tr>
<th>Firms Size</th>
<th>Number of Employee</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro Enterprise</td>
<td>18</td>
<td>45%</td>
</tr>
<tr>
<td>Small Enterprise</td>
<td>17</td>
<td>42.5%</td>
</tr>
<tr>
<td>Medium Enterprise</td>
<td>5</td>
<td>12.5%</td>
</tr>
<tr>
<td>Large Enterprise</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Total</td>
<td>40</td>
<td>100%</td>
</tr>
</tbody>
</table>

Survey data indicates that majority of Estonian exporting firms are new exporters with less than 5 years of experience in export business. Majority of new exporters are Micro firms. Data shows the attraction of entering non EU market for them. Data also indicates that increasing the size of firm has direct relations with export market experience as in contrary to micro firms, majority of medium size respondents have more than 5 years of export experience (cf. Table2). As we will see later in the course of study, experience in export market affects the rate of discrepancy in documentary letters of credit.

Table 2: Export Experience based on Firm Size in Estonian Export Market

<table>
<thead>
<tr>
<th>Period of export Activity</th>
<th>Size</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Micro</td>
<td>Small</td>
</tr>
<tr>
<td>New Exporters (less than 5 years)</td>
<td>Count</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>Percentage</td>
<td>37.5</td>
</tr>
<tr>
<td>Established Exporter (More than 5 years)</td>
<td>Count</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Percentage</td>
<td>7.5</td>
</tr>
<tr>
<td>Total</td>
<td>Count</td>
<td>18</td>
</tr>
<tr>
<td></td>
<td>Percentage</td>
<td>45</td>
</tr>
</tbody>
</table>

The comparison of official sources of main export sectors in Estonia (www.tradewithestonia.com) with results of survey administered among Estonian exporters shows that firms would be divided into six main industry groups plus the IT sector (cf. Table 3).
Table 3: Industry grouping in Estonian export market.

<table>
<thead>
<tr>
<th>Number</th>
<th>Industry grouping</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Food &amp; Equipment</td>
</tr>
<tr>
<td>2</td>
<td>Chemicals and Health</td>
</tr>
<tr>
<td>3</td>
<td>Building and Construction</td>
</tr>
<tr>
<td>4</td>
<td>Machinery /Automotive/ Metal</td>
</tr>
<tr>
<td>5</td>
<td>Forestry / Mining/ Drilling</td>
</tr>
<tr>
<td>6</td>
<td>IT</td>
</tr>
<tr>
<td>7</td>
<td>Others</td>
</tr>
</tbody>
</table>

According to Table 4, the proportion of industries are as following:

Table 4: Proportion of industries to size of firms in Estonian Export Market

<table>
<thead>
<tr>
<th>Cluster</th>
<th>Size</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Micro</td>
<td>Small</td>
</tr>
<tr>
<td>1</td>
<td>Count</td>
<td></td>
</tr>
<tr>
<td>%</td>
<td>5</td>
<td>2.5</td>
</tr>
<tr>
<td>7.5</td>
<td>2.5</td>
<td>5</td>
</tr>
<tr>
<td>4</td>
<td>Count</td>
<td></td>
</tr>
<tr>
<td>%</td>
<td>0</td>
<td>7.5</td>
</tr>
<tr>
<td>25</td>
<td>2.5</td>
<td>15</td>
</tr>
<tr>
<td>12</td>
<td>5</td>
<td>1</td>
</tr>
<tr>
<td>30</td>
<td>15</td>
<td>12.5</td>
</tr>
<tr>
<td>27.5</td>
<td>20</td>
<td>7.5</td>
</tr>
<tr>
<td>40</td>
<td>18</td>
<td>17</td>
</tr>
<tr>
<td>100</td>
<td>45</td>
<td>42.5</td>
</tr>
</tbody>
</table>

Interestingly, among the micro firms, information technology is ranked first, followed with timber industry and food producers. Among small enterprises, machinery producers are the biggest proportion followed by timber industry and IT firms. Machinery producers take the first rank in medium size Estonian exporters group as well. They consist 3 out of 5 medium size exporters in this group. It could be clearly extracted from the data that number of employees has direct relation with moving towards heavy industry.

Main types of documentary discrepancies and discrepancy factors were defined based on survey responses in groups including: Errors in Bill of Exchange,
Commercial Invoice, Packing List, Transport Documents, Inspection Corticated, Movement Certificate. factors for discrepancy where identified as: Late Shipment, Missed Consignment, Late Presentation, Missing Documents, Incorrect Shipment, and others (cf. Table 5).

Accordingly, biggest rate of discrepancy belongs to commercial invoice, followed by packing list and Transport Document.

Table 5: Type and frequency of discrepancies in Estonian Export DLCs

<table>
<thead>
<tr>
<th>Number</th>
<th>Type of Discrepancy</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Bill of Exchange</td>
<td>22</td>
</tr>
<tr>
<td>2</td>
<td>Commercial Invoice</td>
<td>36</td>
</tr>
<tr>
<td>3</td>
<td>Packing List</td>
<td>32</td>
</tr>
<tr>
<td>4</td>
<td>Transport Document</td>
<td>30</td>
</tr>
<tr>
<td>5</td>
<td>Inspection Certificate</td>
<td>24</td>
</tr>
<tr>
<td>6</td>
<td>Certificate of Origin</td>
<td>25</td>
</tr>
<tr>
<td>7</td>
<td>Government Certificate</td>
<td>8</td>
</tr>
<tr>
<td>8</td>
<td>Late Shipment</td>
<td>19</td>
</tr>
<tr>
<td>9</td>
<td>Missed Consignment</td>
<td>12</td>
</tr>
<tr>
<td>10</td>
<td>Delivery Schedule</td>
<td>16</td>
</tr>
<tr>
<td>11</td>
<td>Presentation after Expiry of DLC</td>
<td>26</td>
</tr>
<tr>
<td>12</td>
<td>Missing Documents</td>
<td>21</td>
</tr>
<tr>
<td>13</td>
<td>Incorrect of Partial Shipment</td>
<td>14</td>
</tr>
<tr>
<td>14</td>
<td>Total</td>
<td>285</td>
</tr>
</tbody>
</table>

Since growing the amount of export will have direct effect of increasing the use of documentary letters of credit, it is logical to study correlation between amount of export and possible discrepancy in exporters presentation to the bank.

Application of Spearman Rank Coefficient on responses proves the positive meaningful correlation between increasing the size of export sales with discrepancy in commercial invoice. Outcome is in accordance with principles of ERM by showing the increase in exposure to a particular risk will increase the possibility for its occurrence (cf. Table6).

High number of discrepancies faced by Estonian exporters can be a concern as 82% of respondents to survey commented positively on having rejection problem due to documentary discrepancy. The same problem was confirmed by trade finance officers of banks as well available documents in public sphere (ICC Bangkok, 2002). Magnitude of discrepancy is immaterial as any single documentary discrepancy will result in rejection of presentation by bank. According to the data collected from survey, highest level of discrepancy is evidenced in commercial invoice (about 90%) followed by packing list (about 85%) and Transport Document (70%) (cf. Table 5).
Table 6: Correlation between Percentage of Export Sales and occurrence of discrepancy in exporter’s presentation

<table>
<thead>
<tr>
<th>Percentage of Export to Total Sales</th>
<th>B of E</th>
<th>CI</th>
<th>PL</th>
<th>TD</th>
<th>ID</th>
<th>IC</th>
<th>CO</th>
<th>GC</th>
<th>LS</th>
<th>MC</th>
<th>LP</th>
<th>MD</th>
<th>IS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Correlation</td>
<td>.065</td>
<td>.563</td>
<td>.116</td>
<td>.279</td>
<td>.010</td>
<td>-.031</td>
<td>-.212</td>
<td>-.207</td>
<td>.193</td>
<td>.230</td>
<td>.355*</td>
<td>.162</td>
<td>.072</td>
</tr>
<tr>
<td>Sig. (2 tailed)</td>
<td>.721</td>
<td>.001</td>
<td>.528</td>
<td>.122</td>
<td>.957</td>
<td>.865</td>
<td>.244</td>
<td>.255</td>
<td>.290</td>
<td>.222</td>
<td>.050</td>
<td>.377</td>
<td>.694</td>
</tr>
<tr>
<td>N</td>
<td>33</td>
<td>31</td>
<td>32</td>
<td>32</td>
<td>32</td>
<td>32</td>
<td>32</td>
<td>32</td>
<td>32</td>
<td>30</td>
<td>31</td>
<td>32</td>
<td>32</td>
</tr>
</tbody>
</table>

Surprisingly, number of discrepancies in internal documents are higher than externally produced documents.

The correlation between types of documentary discrepancy and attributes of the export DLC in Estonia is summarized in table 7. Different types of documentary discrepancies are categorized as: Errors in Bill of Exchange, Commercial Invoice, Packing List, Transport Document, Insurance Document, Inspection Certificate, Certificate of Origin and Government Certificate. Meanwhile, table 8 provides correlation between attributes of export DLC in Estonia with different discrepancy factors including: Late Shipment, missed consignment in a predetermined delivery schedule, Documents presented after Letter of Credit expiry, Missing documents, Incorrect shipment/partial shipment. Studying the existing correlation between types of documentary discrepancy and attributes of the DLC defined by Estonian exporters shows that detailed knowledge of UCP 600 only has negative correlation with missing documents. Result is in accordance with findings of the research as detailed knowledge from UCP 600 was not considered an important attribute of the credit by exporters.

In contrary, understanding of the letter of credit process was ranked the most important attribute of the DLC transaction by respondents shows negative correlation with discrepancy in transport document and late presentations. The correlation indicates importance of the attribute in reducing transport document’s discrepancy as a third party issued document which is not under the control of exporter as well as reducing late presentations after expiry of the credit resulting in dishonor of the presentation by bank (cf. Table 7).

Prior experience with letter of credit transaction as another important attribute of the credit shows positive correlation with discrepancy in bill of exchange and negative correlation with discrepancy in transport document as well as certificate of origin (cf. Table 7). Result can be explained as increasing the number of letter of credits used in export business will increase the exposure of Estonian international
business activists with risk of discrepancy and this is visible in positive correlation of discrepancies in bill of lading. However, prior experience with DLC operation shows negative correlation with discrepancy in Transport Document and Certificate of Origin (cf. Table 7). As both documents are issued by third parties, result of study indicates that gaining experience in DLC operation will help exporters in reducing discrepancy in externally issued documents by providing issuers with proper instructions. This is in accordance with findings of research as number of discrepancies in externally produced documents are less than internally issued documents.

The relationship between seller and buyer as other important attribute of DLC operation does not show correlation with discrepancy in any document. Result can be explained with practical custom of international trade where majority of discrepancies are waived by buyer. Country of export, supply and demand market forces and common industry practices as low importance attributes of the DLC operation do not show any correlation with documentary discrepancy in internally or externally produced documents. Formal education in the area of documentary letters of credit show positive correlation with discrepancy in certificate of origin (cf. Table 7). Reason is not known but it can be relevant to external nature of the certificate of origin as it is not produced by documentary staff in exporter’s organization. Prior trading history and relations with bank show negative correlation with late presentation (cf. Table 7)
<table>
<thead>
<tr>
<th>Attributes of DLC</th>
<th>Correlation</th>
<th>B of E</th>
<th>CI</th>
<th>PL</th>
<th>TD</th>
<th>ID</th>
<th>IC</th>
<th>CO</th>
<th>GC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Detailed Knowledge of UCP 600</td>
<td>CC</td>
<td>.292</td>
<td>.257</td>
<td>.212</td>
<td>.076</td>
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Table 8: Correlation between attributes of the export DLC and discrepancy factors

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### Conclusion

Choice of the method of payment is a way to reduce such risk. Documentary Letters of Credit can be a good method for mitigating the risk of payment at it will be shifted from importer to a bank with stronger credit standing. However, documentary credits are conditional guarantees of payment which depend on presentation of compliant documents to the bank within the expiry date of the credit. At the same time, they have a completed process of operation which needs a high level of expertise to operate smoothly. Study of the export letter of credit discrepancies in Estonia shows that majority of the discrepancies are relevant to interlay produced documents. This can be solved by implementation proper process management techniques within the Estonian exporter’s organization. Since existence of documentary discrepancy in DLC transaction can result in rejection of presentation by bank and impose costs of rectification on exporter or in worst scenario end of in bad debt due to documentary rejection, it is necessary for Estonian exporters to look for implementing methods to reduce problems on the way to produce compliant documents. Such solutions can be implementation of Enterprise Risk Management methods, use of process management and process engineering method to create a high accuracy procedure on the way to documentary production including: examination of the accuracy of documents and also proper communication with external parties who are involved in production of third party documents stipulated in the credit. Also Constant training of staff and employing experience documentary staff will reduce the risk of producing discrepant documents. Such efforts will reduce the amount of loss at micro and macro level in Estonian export environment substantially.

### References


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Unified Customs and Practices for Documentary Letters of Credit, UCP 600


6.2. DELIVERY TERMS IN TRANSPORTATION PROCESS OF EXPORT TRADE AND THEIR EFFECT ON THE RISK OF DISCREPANCY IN DOCUMENTARY LETTERS OF CREDIT; EVIDENCE FROM ESTONIA

Hamed Alavi

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Abstract:
Documentary letters of credit (DLCs) are method of payment developed to facilitate the process of international trade by replacing the payment risk of importer with irrevocable payment guarantee of a bank to exporter. Instead, the exporter is supposed to present fully compliant set of documents required by the credit. Documentary nature of DLCs make them vulnerable to the risk of discrepancy. This risk is will affect exporter’s business as he is the one who should absorb it. Therefore, it will be recommended to exporters to negotiate the minimum number of required documents while closing the underlying contract of sales with importer. Since different delivery terms (INCOTERMS) require presentation of different documents, this paper studies the correlation between using different terms of delivery with existence of discrepancy in export DLCs in Estonia. For this purpose, author takes empirical approach to answer following research questions: what is the relation between documentary discrepancy and choice of delivery terms and third party documents? and what is the correlation between above mentioned factors and documentary discrepancy in process of DLC operation in Estonian export landscape?

The paper is divided into four parts: after the introductory section, the literature review will briefly analyses process of international DLC operation and latest version of INCOTERMS plus their role as delivery terms in international trade. Next section will discuss methodology and results of empirical study done on choice of delivery terms and third party produced documents on discrepancy rate in DLC operation in Estonian export trade. Last but not the least, final section will provide conclusions of the study.

1. Introduction

International traders deal with more tangible and intangible risks that their counterparts who only trade in local markers. Such risks (from pre-order placement stage till final delivery of goods) are mostly relevant to the complex process of international trade and need for considering plenty of steps for successfully closing a single deal overseas. Among others, financial risks are considered as a significant concern for exporting parties in international sales contracts. There are different ways to mitigate the financial or payment risk for exporters, however, documentary letters of credit are an appealing payment method among others (Alavi 2017, 29), While being considered as “the life blood of international trade”, DLCs are in fact a complex method developed by traders in the course of time
to reduce the risk of payment by buyers (Alavi 2016b,5). Accordingly, a bank guarantees the payment of shipped goods to the exporter in return for presentation of fully compliant documents with terms and conditions of the credit. In this way, a guarantee of payment by bank as a financial institution has been replaced by payment obligation of importer with much less credit standing. As a result, DLCs have mainly application in cases of international trade between parties with no solid information from each other’s financial background or parties from riskier regions (Alavi2016a,118). There is no public data on amount of DLC transactions annually (Bergami 2006, 54). However, in 2003 the turnover in the USA was approximately USD 51,648 million (Documentary Letter of Credit world 2003). Total amount of trade in the USA at the same period of time was about USD 1,922,724. (The US international trade commission 2004) Therefore, it is possible to conclude that DLCs stand as a method of payment for 4% of international trade.

There is no public information about amount of DLC transactions in Estonia. Interviews with trade finance officers of Estonian banks offering export DLC service to their clients did not result in any meaningful result. The reason can be high level of confidentiality established between banks and their clients as a prerequisite for offering such service.

The process of DLC operation is subject to Uniform Customs and Practices for Documentary Letters of Credit (currently UCP 600) promulgated by International Chamber of Commerce. UCP subjects the operation upon two principles of autonomy and strict compliance. Article 4 of the UCP separates the DLC from underlying contract of sales by providing: “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. “Further, article 5 emphasizes that in the process of DLC operation, banks do not consider goods and only pay attention on compliance of documents: “Banks deal with documents and not with goods, services or performance to which the documents may relate.”

The sole dependency of DLC operation on documents is known as principle of strict compliance. Accordingly, the beneficiary exporter is eligible to receive payment only in case of full compliance of its presentation with terms and conditions of the credit. However, not all documents required in the credit are produced by exporter. The bill of lading, document of insurance and certificate of origin are famous documents which their production is not under the control of exporter. To make the situation even more complicated, choice of different delivery terms (INCOTERMS) directly affects the process of documentary presentation...
as different terms require different documents to be presented. The totality of complex process of DLC operation leads to high rate of rejection of exporters presentations by bank. The result of global study done by ICC shows that 60-70% of presentations are rejected by banks due to non-compliance (ICC Bankok 2002). These results are confirmed in a study done by Mann in the United States. On the other hand, magnitude of non-compliance does not have any effect of bank’s decision to dishonour the presentation (any single discrepancy is sufficient for rejection). As a result, exporters are facing risk of rejection due to need for presentation of documents which they have no control over their production. Outcome of dishonouring a presentation by bank can differ from late payment and extra costs for rectification of documents to imposing bad debts on exports due to documentary discrepancy.

In this paper, author tried to study role of delivery terms and third party documents in process of documentary presentation in DLC operation within the context of Estonian export trade. For this purpose, research questions are formulated as what is the relation between documentary discrepancy and choice of delivery terms and third party documents? And what is the correlation between above mentioned factors and documentary discrepancy in process of DLC operation in DLC in Estonian export landscape?

For this purpose, paper is divided into four parts: after the introductory section, the literature review will briefly analyse process of international DLC operation and latest version of INCOTERMS plus their role as delivery terms in international trade. Next section will discuss methodology and results of empirical study done on choice of delivery terms and third party produced documents on discrepancy rate in DLC operation in Estonian export trade. Last but not the least, final section will provide conclusions of the study.

2. Literature Review

2.1. The process of international DLC Operation

Choice of DLC as a method of payment for an international sales contract will itself lead to a complex web of additional contacts (Bergami, 2006, 50). In this process, after signing the contract of sales between importer and exporter, the importer will ask her bank to open a DLC in favor of exporter. The issuing bank will inform the exporter about request for issuing a DLC via using her correspondent bank is exporter’s country (advising bank). At this stage, exporter should check all terms and conditions of the credit and ask for amendment in case of facing with any problems. After accepting terms and conditions of the credit, issuing bank will sign a contract with exporter and guarantee payment for goods shipped to importer in return for compliant presentation of documents stipulated in the credit by issuing it officially. Exporter might ask for further guarantee which will lead
to involvement of confirming bank and additional contracts between exporter and issuing bank with it. Next step will be shipping goods to importer and collection of documents to be presented to bank. After presentation of documents, bank will examine documents and pay exporter in case of their strict compliance with terms and conditions of the credit. In case of detecting and discrepancy in documents, payment process will be delayed until its rectification or receiving a waiver from importer. It is worth to mention that postponement of delay is depending on examination of documents before the expiry date of the credit and existence of time for taking corrective action. In case of approaching the expiry date of the credit, payment will be canceled and exporter should bear the full lose. Figure 1 illustrates the complex process of DLC operation.

In this process, contract between the exporter (beneficiary) and bank is the main obligation for payment against presentation of compliant documents. As it is clearly visible, importer (applicant) is not a party to contract between the bank and
beneficiary. As a result, and with reference to principle of autonomy (explained earlier) the bank is not concerned with performance of underlying contract of sales between importer and exporter. Mere presentation of compliant documents by beneficiary will make him eligible to receive payment from bank. However, different factors affect the number and level of complexity of documents required in presentation. Among others, choice of deliver terms will affect the number and complexity of documents required in presentation.

2.2. INCOTERMS

Internationally recognized delivery terms applied to DLCs are INCOTERMS which stand for International Commercial Terms. In the same manner to UCP, INCOTERMS are product of International Chamber of Commerce and first version of them was published in 1936,(Bergami 2013b,328). INCOTERMS divide the rights and responsibility of seller and buyer in accordance chosen term of delivery by parties to the contract of sales (Mudrić, 2013,410). Accordingly, they indicate the moment which risk of goods in transit will pass from the seller to the buyer. (Susmus& Baslangic, 2015,322) Currently, Incoterms 2010 are in latest available version and consist 11 delivery terms which are divided into four main groups:

Figure 2: INCOTERMS 2010

The minimum documentary requirement for LC would be under E group which consists of EX Work( Paliu-Popa 2012,100). In case parties to the sales contract agree on delivery of goods under EX Work, seller does not have any obligation to
clear goods from customs of exporting country, arrange for carriage or insurance of goods during the carriage as delivery either takes place at seller’s premise of business or an agreed upon place in exporting country. Such arrangement would obviously affect the number of documents required under LC and minimize them to the internally issued documents by seller (Stapleton et al. 2014, 228). There is no doubt the reducing the number of stipulated documents to ones internally produced by exporter will reduce the risk of discrepancy drastically. The EXW is a risk factor in L/Cs from the point of view of issuing bank. Because issuing bank request the transport docs should be “issued to the order of” or “consigned to name of” their selves. But EXW legally means directly delivery of the goods to the importer. This situation contradicts with logic of L/C. On the other hand, Delivery Duty Paid (DDP) is the delivery term which will impose highest level of responsibility on the exporter as it requires the passage of risk of goods in transit from seller to the buyer after clearing goods from customs of importing country. Each of other terms in between EX Work and DDP have their own characteristics and documentary requirements in letter of credit operation. Group F includes FCA (Free Carrier suitable for Multimodal Transport), FAS (Free Alongside Ship) and FOB (Free on Board together suitable for Maritime Transport). In this group, exporter is only obliged to provide custom clearance and deliver goods at agreed point before commencement of international transport (Ramberg, 2010). While under F group exporter is in need of providing further documents, there is no obligation to get inside the contract of carriage. However, he can offer such option on importers cost and responsibility which means need for presentation of transport document. Group C includes CFR (Cost and Freight), CPT (Carriage Paid to), CIF (Cost, Insurance and Freight) CIP (Carriage and Insurance Paid to). Entering an agreement with importer to deliver goods under group C terms will oblige exporter to present contract of carriage. Additionally, under the CIF (maritime transport) and CIP (multimodal transport), exporter is obliged to present the document of insurance. Therefore, increasing number of third party produced documents would definitely effect the compliance of presentation (Bergami 2006b, 54).

Group D includes DAT (Delivery at Terminal), DAP (Delivery at Place) and DDP (Delivery Duty Paid). Under this group of delivery terms, exporter is obliged to place the goods at the agreed point of delivery, mainly country of the importer (Bergami 2013a, 37). Since exporter holds the risk of delivery, insurance document is not required when group D terms are agreed upon is the underlying sales contract between parties. The proof of delivery also depends on type of documents agreed upon by parties.

As it was explained, the choice of delivery term affects required documents under the DLC substantially. Since some documents will not be produced by exporter, he will not have any control of their production process which might lead to existence of discrepancy because of possible mistakes made by respective producer.
3. Research Design

Due to absence of public data on Estonian export trade finance and methods used by Estonian exporting firms in reducing their payment risk, this research took an empirical approach and collected data by using Bank interviews, and Exporters’ survey questioners.

The exporters’ survey followed the goal of measuring the correlation between the variables describing documentary discrepancies, INCOTERMS used in Estonian export DLCs and third party issued documents.

Data collected from the survey then supplemented with semi structured interviews with trade finance officers in three Estonian banks offering export trade finance services. Due to small number of banks offering export DLCs in the country, the semi structured interview method was chosen over survey method. The results of interviews were used as a complementary data providing explanation to the exporters’ survey results.

3.1. Data Collection and Analysis

After taking sampling test of three companies, survey questionnaires were administered among Estonian exporting companies. The respondents to test were not included in the main sample. Data collection took place between June and September 2016 while transactions done in fiscal year of 2014-15 were questioned. The interviews with the banks trade finance officers took place at the same period.

Number of distributed questionnaires totalled 1200 in accordance to the data in the Estonian Export Directory (www.estonianexport.ee). Based on collected data from trade finance officer’s interviews, approximately 100 to 150 Estonian exporting companies apply DLC as a method of payment in their trade. Collected number of responses in September 2016, reached 41, which equals 27.3 percent of total companies. As a result, the collected data are sufficient for this research, despite of comprising a small proportion of distributed questionnaires (3.41%). Among collected data one response was not valid, therefore, only 26% of the total population were responding which can be considered representative.

Data analysis took place by using the Spearman Correlation Rank method in order to find the correlation between discrepancies evidenced in the exporter’s survey with selected variables. Descriptive statistics, was also used to provide explanation of the correlation analysis results. The data were analyzed using the SPSS Statistics 24. Statistical significance of the results was estimated on the 95% confidence level.
3.2. Discussion

Analyzing the data from Figure 3 shows that CIF is the most used incoterm by Estonian exporters. Therefore, it would be expectable that exporters are supposed to tender insurance and transport documents in addition to internal documents prepared by their own staff. FOB is the second ranked delivery term which is mostly involve exporter in tendering the transport documents. Despite the moderate use of multimodal transport terms, it is interesting that 70% of Estonian exporters use EXW which has the minimum documentary requirement and more than 90% of them do not use DAT, DAP and DDP with maximum documentary requirements. The other reason for lack of interest among Estonian exporters to apply D terms can be traced to time factor. Generally, delivery of goods to buyer under D terms will be evidenced by a delivery receipt signed by the buyer. This will impose additional risk of delivery time to exporter as transport and custom clearance process in the importing country might take more that expiry date of the credit.

The outcome of the survey administered to Estonian export companies shows main types of documentary discrepancies and discrepancy factors as following: Errors in Bill of Exchange, Commercial Invoice, Packing List, Transport Documents, Inspection Corticated, Movement Certificate. factors for discrepancy where identified as: Late Shipment, Missed Consignment, Late Presentation, Missing Documents, Incorrect Shipment, and others.

Figure 3: indicates frequency and types of discrepancy.

<table>
<thead>
<tr>
<th>Number</th>
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<th>Frequency</th>
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</thead>
<tbody>
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<td>3</td>
<td>Packing List</td>
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<td>4</td>
<td>Transport Document</td>
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<tr>
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<td>Inspection Certificate</td>
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</tr>
<tr>
<td>6</td>
<td>Certificate of Origin</td>
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</tr>
<tr>
<td>7</td>
<td>Government Certificate</td>
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</tr>
<tr>
<td>8</td>
<td>Late Shipment</td>
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</tr>
<tr>
<td>9</td>
<td>Missed Consignment</td>
<td>12</td>
</tr>
<tr>
<td>10</td>
<td>Delivery Schedule</td>
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<tr>
<td>11</td>
<td>Presentation after Expiry of DLC</td>
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</tr>
<tr>
<td>12</td>
<td>Missing Documents</td>
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</tr>
<tr>
<td>13</td>
<td>Incorrect of Partial Shipment</td>
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</tr>
<tr>
<td>14</td>
<td>Total</td>
<td>285</td>
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</table>

As it can be traced in the table, commercial invoice has highest rate of discrepancy, followed by packing list and then Transport Document.
Figure 4: Usage of INCOTERMS 2010 in Estonian Trade

According to above mentioned explanation, choice of some INCOTERMS like CPT, CIP, CFR and CIF as well as FOB will face exporter with necessity to ask for third party documents which he has no control over their production process. Although, third party will issue required documents on the basis of the exporter’s information, but different factors (non controllable by exporter) might increase risk of documentary discrepancy which exporter should bear its loss. Therefore, current section is devoted to analysis of data collected from survey regarding most important INCOTERMS and their role in documentary discrepancy during LC presentation.

Figure 5: Use of INCOTERMS by percentage
Result of applying Spearman’s Rank Coefficient in analyzing the data collected from survey is in accordance with above mentioned statements. First of all, there is no meaningful correlation between use of EXW and discrepancy in any of surveyed documents. This proves that adherence to minimum documentary obligations will reduce the level of discrepancy. CIF as the most frequently used INCOTERM shows a positive relation with discrepancy in Transport Documents, Insurance Document, Government Certificate and Missing Deliveries. Interestingly, FOB does not show any correlation with occurrence of documentary discrepancy. There is no explanation for such finding, however, lack of insurance document and responsibility of arranging the vessel by buyer can clearly explain the not existence of correlation with relevant document. Carriage and Insurance Paid to (CIP) is the equal of CIF in multimodal transport for and using it has positive correlation with discrepancies in insurance document, certificate of origin and government certificate. This is a meaningful outcome as relevant document are all external documents which none of them will be produced under control of exporter. However, the use of CIP shows negative correlation with discrepancies in bill of exchange. Carriage Paid To shows positive correlation with discrepancies in government certificate and certificate of origin. Free Carrier shows positive correlation with discrepancies in packing list, transport document and late presentations. Cost and Fright which indicates payment of shipping freight by exporter also shows positive correlation with transport document and packing list
Figure 6: Correlation between use of INCOTERMS 2010 and LC documentary discrepancy

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<tr>
<th></th>
<th>B of E</th>
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|                  | B of E | CI    | PL    | TD    | ID    | IC    | CO    | GC    | LS    | MC    | LP    | MD    | IS    |
| CIF C C Sig.     | .095   | .085  | .342  | .460**| .359* | .049  | .207  | .361* | .338  | .109  | .014  | .361* | .310  |
| (2-tailed) N     | .592   | .645  | .051  | .007  | .040  | .787  | .248  | .039  | .054  | .560  | .941  | .039  | .079  |
| DAT CC Sig.      | -.007  | -.093 | .373* | .215  | .021  | .147  | .221  | .247  | .334  | .045  | -.215 | .190  | .371* |
| (2-tailed) N     | .970   | .639  | .046  | .253  | .913  | .437  | .240  | .189  | .072  | .819  | .262  | .313  | .044  |
| DAP CC Sig.      | .048   | -.547 | .118  | -.062 | .181  | .072  | .384* | .306  | .188  | -.123 | -.274 | .410* | .287  |
| (2-tailed) N     | .802   | .070  | .541  | .743  | .340  | .706  | .036  | .100  | .320  | .532  | .150  | .024  | .124  |

|                  | B of E | CI    | PL    | TD    | ID    | IC    | CO    | GC    | LS    | MC    | LP    | MD    | IS    |
| CIF C C Sig.     | .095   | .085  | .342  | .460**| .359* | .049  | .207  | .361* | .338  | .109  | .014  | .361* | .310  |
| (2-tailed) N     | .592   | .645  | .051  | .007  | .040  | .787  | .248  | .039  | .054  | .560  | .941  | .039  | .079  |
| DAT CC Sig.      | -.007  | -.093 | .373* | .215  | .021  | .147  | .221  | .247  | .334  | .045  | -.215 | .190  | .371* |
| (2-tailed) N     | .970   | .639  | .046  | .253  | .913  | .437  | .240  | .189  | .072  | .819  | .262  | .313  | .044  |
| DAP CC Sig.      | .048   | -.547 | .118  | -.062 | .181  | .072  | .384* | .306  | .188  | -.123 | -.274 | .410* | .287  |
| (2-tailed) N     | .802   | .070  | .541  | .743  | .340  | .706  | .036  | .100  | .320  | .532  | .150  | .024  | .124  |
Delivery at terminal, Delivery at place and Delivery duty paid are terms which show the highest risk for exporter as risk will pass from him to buyer after passing the custom of importer’s country. Accordingly, use of delivery terms from this group have positive correlation with missing deliveries, late personation incorrect or partial shipment. Additionally, delivery at terminal shows positive correlation with discrepancies in packing list. However, due to nominal use of these terms by Estonian exporters, importance of discrepancies resulted from their use in international LC transaction is under question.

Stipulation of third party documents in LC is directly relevant to agreement of parties and INCOTERM used in the underlying sales contract. Among others, bill of lading, Non Negotiable See Waybill , Air waybill , Certificate of Origin , inspection certificate and government certificate are studied.

Among externally produced documents, each one has a particular purpose and relevant risk in their production process differs from one to the other.

Among popular externally produced documents, Certificate of Origin and Government Certificate are documents generally issued by public authorities. Inspection certificate can be issued by public or private authority and transport documents including bill of lading, NNSWB and Airway bill are documents which are issued (in general) upon dispatch of contracted goods by carrier.

Figure 7: Use of third party documents in Estonian Export Trade

Certificate of origin is a document produced by National or Local Chamber of Commerce. Mostly, it follows the intention of proving the original source of producing
exported goods. Different reason can be involved for requiring such document including: preferential duty treatment available for importers, regulatory issues in importing country or simply buyer’s requirement. Government certificate, however, is issued for the purpose of meeting import regulations of destination country. It is low risk of discrepancy involved in production of above mentioned documents as most of involved national authorities are familiar with international regulations, and they use standard templates for production of such documents. Additionally, all parties to the credit are familiar with documentary requirement of doing trade with a particular country. Despite the fact that existence of standard requirements and familiarity of parties with such requirements plays a significant role in reduction of risk of discrepancy, but they do not eliminate this risk completely. In fact, human errors can play a significant role in discrepancy of government certificate and/or certificate of origin. Although, relevant forms to quarantine permits are filled in by the exporter’s staff which will reduce the risk of human errors, but public agencies do not require a copy of LC in order to issue certificate of origin or government certificate. Therefore, there is always a portion of risk remains that lack of access to the credit and knowledge from its requirements will create problem on the way of producing a compliant document by public agencies.

Inspection certificates are “carried out prior to the shipment of the goods [pre-shipment inspections] and most pre-shipment inspections are voluntarily requested by the private sector” (Jeker & Balchin 2005, 575). The main purpose of conducting such inspections are “assure the importer that the goods conform to the technical specifications and the quality standards laid down in the contract and that the quantities exported are accurate” (International Trade Centre UNCTAD/WTO and Commonwealth Secretariat 1999, 72) via “through an independent agent such as an inspection company” (Johnson, 1997). In contrary with public agencies, buyer who is responsible for hiring the inspection agency provides it with a copy of the credit. As a result, goods will be tested “at the place of manufacture or assembly prior to dispatch” with outcome of issuing “a clean report” where goods comply with requirements of the credit and “discrepancy report” when they don’t.

Despite the fact that reason for presentation of inspection certificate under the credit is not known, it is possible to consider it in current study relevant to commercial purpose of parties. This is further emphasized by Article 4 and 5 of the UCP 600 which clarify that in letter of credit transaction, bank does not have anything to do with goods. It only deals with documents. Further, the principle objective of letter of credit operation implies that bank procures the goods from seller instead of buyer. Therefore, in case of buyer’s bankruptcy before paying his relevant debt to goods in transit, bank should have security on goods and be able to turn them into cash with no problem. Since bank is not a party to the underlying contract of sales, existence of a certificate of inspection will reduce the possibility of fraud or shipping low quality goods by seller and making bank stocked in non-favorable of situation in which it cannot either get the money paid to seller from the buyer or exchange shipped goods for a fair value of money. Since both inspection agency
and exporter have a copy of the credit, there is low risk of facing with discrepancy in inspection certificate. This hypothesis is in accordance with results of survey which show 35% of participants never faced such discrepancy and other 35% faced with it in a less than 25% of occasions).

Another important document is insurance document. However, majority of exporters issue the insurance policy which enables them to issue the insurance document internally. Almost 70 percent of Estonian exporters participated in current study confirmed their use of open policy for insurance of shipped goods. Such practice enables to mitigate the risk of discrepancy in insurance document.

Despite the fact that issuing party of the transport document are not always the carrier, but it is an always externally issued document. If not the carrier, generally, freight forwarders are the ones who are responsible for issuing the transport document. As middle men, their responsibility is to provide common business services for the exporter and at the same time prepare goods to be shipped by carrier. They might issue the “received for shipment” bill of lading or even the main document of transport as agent of carrier in case of air transport. Freight forwarders receive instructions from the exporter via shipper’s letter of instruction. Empirical data from the survey shows that all respondents use services of freight forwarders. Although not clear, but due to use of EX Work by substantial group of Estonian exporters (15%) use of freight forwarders services cannot be equal among respondents.

The application of Spearman Rank Coefficient shows the positive correlation between use of bill of lading and discrepancy in commercial invoice and negative correlation with certificate of origin. Reason for positive correlation can be explained based on application of strict compliance principle which requires consistency in data available in each document with terms of credit as well as consistency data in different documents. Therefore, inconsistency between data in commercial invoice and bill of lading can result in dishonoring presentation by bank due to discrepancy in commercial invoice. The reason for negative correlation with discrepancy in certificate of origin is not known and it can be a topic for further research. NNSW shows positive correlation with discrepancies in Commercial Invoice and negative correlation with discrepancies in insurance document and certificate of origin. Again similar line of reasoning can be used for explanation of positive and negative correlations. Air Waybill and Government Certificate are the least used third party documents. Among them, use of Air Waybill does not show any correlation with discrepancy in different document, but Government Certificate shows correlation with Late Presentation. This can be explained as getting stock in official process for getting the certificate may result in late presentation after the expiry of the credit. Certificate of Origin shows positive correlation with Inspection Certificate and Inspection Certificate shows negative meaningful correlation with Incorrect or partial shipments. Reason is not known and can be an element for further research.
Figure 8: Use of third party documents and LC Documentary Discrepancies

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<th>IC</th>
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<td>.046</td>
<td>-.177</td>
<td>-.192</td>
<td>-.264</td>
<td>-.017</td>
<td>.052</td>
<td>.241</td>
<td>.325</td>
<td>-.204</td>
<td>-.466**</td>
</tr>
<tr>
<td>Sig.</td>
<td>.172</td>
<td>.162</td>
<td>.204</td>
<td>.802</td>
<td>.332</td>
<td>.293</td>
<td>.144</td>
<td>.924</td>
<td>.778</td>
<td>.199</td>
<td>.075</td>
<td>.264</td>
<td>.007</td>
</tr>
<tr>
<td>(2-tailed)</td>
<td>N</td>
<td>33</td>
<td>31</td>
<td>32</td>
<td>32</td>
<td>32</td>
<td>32</td>
<td>32</td>
<td>32</td>
<td>30</td>
<td>31</td>
<td>32</td>
<td>32</td>
</tr>
<tr>
<td>Government Certificate</td>
<td>-.327</td>
<td>-.123</td>
<td>-.073</td>
<td>.121</td>
<td>-.154</td>
<td>.060</td>
<td>-.004</td>
<td>.015</td>
<td>.092</td>
<td>.015</td>
<td>.363*</td>
<td>-.136</td>
<td>-.332</td>
</tr>
<tr>
<td>Sig.</td>
<td>.063</td>
<td>.511</td>
<td>.693</td>
<td>.511</td>
<td>.400</td>
<td>.746</td>
<td>.983</td>
<td>.936</td>
<td>.615</td>
<td>.938</td>
<td>.044</td>
<td>.457</td>
<td>.064</td>
</tr>
<tr>
<td>(2-tailed)</td>
<td>N</td>
<td>33</td>
<td>31</td>
<td>32</td>
<td>32</td>
<td>32</td>
<td>32</td>
<td>32</td>
<td>32</td>
<td>30</td>
<td>31</td>
<td>32</td>
<td>32</td>
</tr>
</tbody>
</table>
4. Conclusions

Documentary letters of credit (DLCs) are a method of payment used between international traders. Using DLCs will help parties with little understanding from each other’s financial standing to close a deal. This is the main advantage of using DLCs as they promoted the flow of international trade by replacing the guarantee of bank to pay exporter instead of importer’s obligation. In this way, exporter is assured that he will be paid either before or immediately after parting from shipped goods. However, application of principle of strict compliance in operation of DLCs make exporters vulnerable to risk of dishonoring the presentation by bank due to documentary discrepancy. Since dishonoring the presentation may create significant problems for exporters, they need to be aware to minimize this risk as much as possible.

By analyzing role of delivery terms and third party documents in process of DLC operation within the context of Estonian export landscape, this paper showed importance of choosing suitable delivery terms at the time of concluding underlying contract of sales between importer and exporter. Since different INCOTERMS require different documentary supplement, it is recommended for exporters to minimize the risk of discrepancy by negotiating the EXW as delivery term of choice. At the same time, it is important for exporter not to expose himself to risk of delivery due to need for complicated third party issued documents. INCOTERMS like CIF and CIP require presentation of a bundle of documents which some of them including insurance and transport documents are not issued under exporter’s supervision. This is a huge risk which might create substantial delay in payment process due to existence of discrepancy because of a simple mistake done by third party employees. As a result, exporters are strongly advised to take maximum advantage of DLC operation by mitigating the risk of discrepancy and negotiating most favorable delivery term at the time of closing the underlying contract of sales with importer rather than looking for legal and financial solutions after facing with rejection of presentation by bank.

5. Bibliography


ICC Bankok 2002: “I would say that probably 70 per cent of our documents at the moment are okay on first presentation and 30 percent would probably have to go back to them and try and get the documentation corrected”

International Trade Centre UNCTAD/WTO and Commonwealth Secretariat 1999, 72


Johnson, T, E. (1997), Export/import procedures and coumentation, American Management Association, NewYork, NY, USA


The US international trade commission 2004
6.3. RISK MANAGEMENT TECHNIQUES AND THEIR APPLICATION TO DOCUMENTARY DISCREPANCY IN LETTER OF CREDIT TRANSACTION

Hamed Alavi

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Abstract
With emergence of new economies in globalized world issue of international trade is gaining more ground in economic, political and development debates. Economic liberalization as well as removing tariff and non-tariff barriers to trade, has significantly contributed to globalization of production and flow of business. At the same time increasing trade with emerging economies and moving production to low cost countries resulted in increasing trade risk more than before. Among others, payment risk can impose serious amounts of loss on involved parties in international trade while traders try to mitigate it by using different methods of payment like documentary credits. LCs are used to reduce the payment risk of buyer with irrevocable guarantee of issuing bank to pay contractual price to seller against presentation of complying documents by him. However, application of Strict Compliance Principle and reliance of banks on mere documentary nature of presentation rather than trade realities between partners can create different problems. A prominent example of such problem is rejection of payment by bank due to bad processing and noncompliance of presented documents by beneficiary. In fact, non-compliance is a huge risk for beneficiary which can result in his significant financial loss. By focus on potential financial loss due to mismanagement of risk, current paper tries to study most prominent risk management techniques and their applicability to mitigate the risk of documentary discrepancy in LC transaction from the perspective of exporter beneficiary and find answer to the question of which Risk management model can be suitable to reduce such risk in LC operation. Research consists of three parts. First, it will review history and different business risk management philosophies. Second part will discuss to nature of LC transaction and risk of documentary discrepancy while final part will analyses different business risk management techniques and their usefulness in mitigating the risk of documentary discrepancy in international LC transaction.

Keywords: risk management, business, trade, bank.

Introduction
International trade is a risky process which calls for awareness of exporters to take reasonable payment measures before departing form their goods in favor of importers. For this purpose, four general payment methods are used all around the globe, namely, Prepayment, Open Account, Documentary Collection and Documentary Letter of Credits. Economic liberation and emergence of new markets in different corners of the globe is a tempting reality for businessmen to expand
their trade further by doing business with new partners from new markets. Such business activities are risky and trader might incur huge losses due to different problems in process of practicing business. Documentary Letters of Credit are used in international trade as payment method in order to hedge commercial risks which exporter and importer might face during trade with an unknown or even a known partner from high risk economy. In fact, Documentary Letter of Credit is irrevocable promise of issuing bank to pay price of exported materials to seller instead of importer who will reimburse bank within a different contract. Letters of Credit are considered to be the most popular financial instrument used in international transactions by exceeding a trillion USD per year (Klein, 2006). As a result, it is not unexpected for scholars to call them as “life blood of international commerce” (D’Arcy et al., 2000). Documentary Letters of Credit are subjected to Uniform Customs and Practice for Documentary Letters of Credit as of set international rules codified by International Chamber of Commerce after First World War. UCP has been updated constantly on the basis of market demand and technology developments in international trade. Its most recent version came into effect on 1 July 2007 as UCP 600. According to UCP 600, LC transaction is subjected to two fundamental principles of independence which separates the Credit from underlying contract and strict compliance which conditions honoring the Credit by bank to compliant presentation of required documents in the credit by beneficiary. 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 principle if he acts in accordance with his instructions.” (King, 2003). 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.

b) 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 complexed process and interactions between bank and traders in LC transaction, there is high probability for occurrence of documentary discrepancy. Risk of financial loss and dishonoring presentation by bank will raise when there is no possibility to resolve discrepancies. Such discrepancy can be considered as a significant risk for exporter as according to ICC global rate

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4 Interalia Article 2; Article 7(a), Article 8(a)(c) and Article 15; Article 14 and Article 34 of UCP 600
of documentary discrepancy in LC transaction is about 60-70 % (ICC Thailand, 2002) Documentary discrepancy rate in USA is considered about 73 % while in UK it has been estimations are amounted up to 50-60 % (Mann, 2000; SITPRO Ltd, 2003); Despite the fact that costs of documentary discrepancy has not been studies globally, but SITPRO study showed “that in 2000 the UK lost £ 113 million through non-compliant documents being presented under Letters of Credit” (SITPRO Ltd, 2003).

The majority of discrepancies in practice of Documentary Letters of Credit include inconsistent data, discrepant documents of transport, mistakes in draft, drafts without signature and inconsistent invoice with credit, inadequate insurance, and documents with wrong signature (UCP 600, Articles 14(d), 19, 18(c), 28).

In reality, contrary to the principle of independence, 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 about what constitutes the complying presentation which can be traced into relevant legal cases (Botosh, 2000). Central point to this research is mismanagement of risk that will cause potential financial loss in operation of Documentary Letters of Credit and finding most suitable risk management model in order to mitigate it. In order to achieve its objectives, research will start with review of risk management process and continue with analyzing possible types of discrepancy as well as most sensitive areas of Documentary Credit Operation in which discrepancy might occur. Finally, different existing risk management models will be analysed in order to define the most suitable model in managing the risk of discrepancy in Letter of Credit Operation.

2. Discussion

2.1. Risk Management Review

Scholars believe that roots of the word risk go back to Italian work riscare which means ‘to dare’. According to Christensen to dare in South Europe of renaissance period could be: “a concept of action with uncertainty, potential benefit and possible injury or loss” (Christensen, 2006). In early 20th century, Knight recommends to separate concepts of risk and uncertainty from each other (Bergami, 2011). According to him, uncertainty will apply to the condition in which chances cannot be calculated and it is not possible to define the probability of an event.

In late 20th century and early 21st century, the area of risk management has been subject of research for many scholars and interestingly, many of them attributed risk to a predictable or not predictable event with clear negative consequences (Marshall, 2001; Koller, 2007). Above mentioned scholars agree to refer to negative
consequences of an event as Risk while positive consequences are considered as opportunity. As an outcome, risk is generally considered as a negative issue which comes from reality that “too many organizations risk is a four letter word that they try to insulate themselves from” (Merna, Al-Thani, 2005).

Consequently, scholars such as Borge, Chorafas and Sadgrove provide definition for risk based on negative aspects of risk including: “risk means being exposed to the possibility of a negative outcome” (Borge, 2001), “risk as the chance of injury, damage or loss; a hazard” (Chorafas, 2001) “risk – the possibility that a hazard will cause loss or damage” (Sadgrove, 2005) and “risk is the possibility that an event will occur and adversely affect the achievement of objectives” (Committee of Sponsoring Organisations of the Treadway Commission, 2004). Such negative bias towards meaning of risk has affected definitions of risk management provided by scholars as well. For example: “risk management is the practice of protecting an organisation from financial harm” (Blake, 2003) and, “as being concerned with identifying and managing a firm’s exposure to financial risk” (Kaen, 2005). Some scholars point at opportunity in providing definition for risk management: “risk management is the application of analysis techniques and the definition of measures to quantify the amount of financial loss (or gain) an organisation is exposed to” (Gorrod, 2004) and “if you approach risk management as a discipline …you are concerned with the opportunity for gain as well as loss” (Frame, 2003).

Despite the fact that there are many credit risk evaluation methods developed for banks in order to help them in valuation of their different products, no model as such has been developed from the point of view of exporter. (Pridotkienė et al., 2006). Many of such models which are designed only to meet requirements of bank will not benefit exporter as evaluation of risks incurred by exporter as each party to the letter of credit has different interests in LC transaction. However, before, studying applicability of existing risk management techniques and their application to mitigate of risk of documentary discrepancy in LC from the perspective of exporter, it is necessary to find out major types of documentary discrepancy and their areas in LC operation in which exporter might face with such risk.

2.2. Complex Operation of Documentary Letters of Credit

Basically, the process of issuing a Letter of Credit starts with request of Buyer (applicant or Account Party) to his bank (issuing bank) in order to issue a credit in favour of the seller (Beneficiary) based on the underlying contract of sales between parties. As a result, issuing bank will contact beneficiary in his country in order to inform him about opening the credit in his favour. Due to a geographical distance between issuing bank and beneficiary, advise of the credit to beneficiary will generally takes place via a correspondent of issuing bank in beneficiary’s country (advising bank). The responsibility of advising bank is only informing beneficiary about issuing credit in his favour and it does not have any obligation of
payment towards beneficiary (UCP 600, Article 9.a). As a result, the legal nature of relationship between issuing bank and advising bank is considered as relationship between agent and principle.

Beneficiary seller at this stage must compare terms and conditions of the credit with terms of underlying contract. In case of any existing discrepancy at this stage, beneficiary is entitled either to reject the credit or require amendments. After approval of the credit by beneficiary, issuing bank will enter into a contract with Beneficiary to provide him with price of merchandise in return of complying documents required in the credit. As a result, any given credit will have at least three parties. Namely, Issuing bank, Beneficiary and Applicant. However, in practice number of parties might be more than three. It might happen that issuing bank asks advising or any other bank in the country of seller to provide credit on her counter which is a very appreciated option for beneficiary who will be paid in his own country rather than the country of the buyer. In this case, the bank which provides credit on her counter is considered as Nominated Bank (UCP 600 – Article 2). In some occasions, seller might ask for higher guarantee for payment which is already provided by issuing bank. In this case a confirming bank will add her irrevocable commitment for payment of the credit to beneficiary in addition to issuing bank. After receiving approval from seller, the buyer will require issuing bank to open a credit in favour of exporter. In case of issuing bank’s agreement to issue the credit, Importer (account party) will pay bank the price of goods sold to him in return of receiving confirming stipulated documents in the credit presented by beneficiary to the bank (UCP 600 – Article 7). If parties decide to advise the credit to beneficiary via bank in his own country, then the advising bank will contact the beneficiary in order to inform him about the issuing of the credit in his favour. At the time that credit requires involvement of Nominated Bank or Confirming Bank, there will be a separate contract between Beneficiary and Nominated or Confirming Bank and Issuing Bank and Nominated /Confirming Bank. Advising Bank might or might not accept to act in the capacity of Nominated and /or Confirming Bank.

As a result, beneficiary ships goods for account party and presents confirming stipulated documents in the credit to the issuing bank, Nominated Bank or Confirming Bank. Nominated Bank will check presented documents and in case of conformity, they will pay beneficiary based on the authorization in issuing bank (Längerich, 2009), transfer documents to issuing bank and wait for reimbursement (UCP 600, Article 7(C). Issuing bank also check documents and in case of their conformity will reimburse Nominated or Confirming Bank, debit the account of applicant and inform him to come and receive his documents.

As it was mentioned earlier, most of the time credit will require the involvement of Nominated Bank and Confirming Bank as Issuing bank is not located in country of Beneficiary and it is difficult for him the confirm the authenticity of signatures by issuing bank (Längerich, 2009).

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5 Gian Singh and Co Ltd v Banque de l’Indochine [1974] 1 WLR 1324, 1238
Above mentioned figure can illustrate complexed process of LC operation as it has been explained before.

Among different steps in LC operation, steps 4 (advise of LC to beneficiary), 5 (shipping goods to applicant) and 6 (submitting documents to bank) have crucial role in encountering with risk of documentary discrepancy. At the stage of advising LC by advising bank to beneficiary, it is recommended that beneficiary should check all terms and conditions of LC against underlying sales contract in order to confirm their compliance.

In case of non-compliance between them, beneficiary should ask for amendment and define deadline for submission of amendment by issuing bank. Beneficiary is also recommended to check list of necessary documents to be tendered according to terms of the Credit. In case of any problems with documents, beneficiary should immediately inform applicant for corrections. While all problems with LC format have been solved, beneficiary is supposed to ship goods to applicant and tender complying documents in timely manner to bank in order to receive his payment. Preparation of documents can be a difficult job as only some of them like invoice and packing list are produced in-house and under exporter’s discretion while some very important documents including transport documents, certificate of origin, independent inspection certificates and other legalized documents are issued by third parties and beneficiary has no control on accuracy and length of time taken for their preparation.

### 2.3. Main cases of documentary discrepancy

Baker, Jimenez, Mehta, as well as Wickermerante and Rowe are among scholars who explored major areas of documentary discrepancy in international LC operation (Baker, 2000; Jimenez 1997; Mehta, 1999; Wickremeratne & Rowe, 1998) In addition to examples which have been already analysed about possible areas of document discrepancy, findings of above mentioned researchers, provide more details on the subject matter as:

- Missing the deadline for shipment of goods and documents
- Incomplete documentary presentation
- Data conflict in presented documents
- Wrong information on commercial invoice
- Using incorrect currency in insurance policy
- Issuing the insurance policy after shipment of goods
- Presenting non-legalized documents
- Presenting documents with incorrect format
- Presenting unsigned documents

Also Mann in his study of 500 five hundred Letters of Credit provides most in-depth inquiry into the letter of credits discrepancies. “The documents presented in the 500 transactions I examined conformed to the Letter of Credit only 27% of the time” (Mann, 2000). Outcome of Mann’s study is in accordance with findings
of ICC regarding global rate of documentary discrepancies. Despite the fact that Mann comments on waiving almost all cases of documentary discrepancy by applicant buyer, and his findings are criticized by other scholars in the field, but the Table 1 where he concludes that sources and types of documentary discrepancy in LC transaction is valuable contribution for identification of and prevention of such risk for exporter beneficiaries (Bergami, 2011).

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6 Discrepancy can be considered as a significant risk for exporter as according to ICC global rate of documentary discrepancy in LC transaction is about 60-70%. Documentary discrepancy rate in USA is considered about 73% while in UK it has been estimations are amounted up to 50–60%. For detailed data please visit: ICC Thailand 2002, Examination of documents waiver of discrepancies and notice under UCP500, ICC Thailand, (viewed 15 July 2015) http://www.iccthailand.or.th/article2.asp?id=9 (visited 10 January 2017); SITPRO Ltd. 2003, Report on the use of export letters of credit 2001/2002, SITPRO London. 2005, Letters of credit – an introduction, SITPRO Ltd,( viewed 10, January 2017)
Table 1. Sources and types of documentary discrepancy in Letter of Credits (Mann, RJ, 2000):

<table>
<thead>
<tr>
<th>Type of discrepancy</th>
<th>Occurrence</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defective Documents</td>
<td>293</td>
<td>85%</td>
</tr>
<tr>
<td>Missing Documents</td>
<td>75</td>
<td>22%</td>
</tr>
<tr>
<td>Late Shipment</td>
<td>62</td>
<td>18%</td>
</tr>
<tr>
<td>Late Presentation</td>
<td>48</td>
<td>14%</td>
</tr>
<tr>
<td>Expired</td>
<td>36</td>
<td>11%</td>
</tr>
<tr>
<td>Overdraft</td>
<td>16</td>
<td>5%</td>
</tr>
<tr>
<td>Incorrect Shipment</td>
<td>14</td>
<td>4%</td>
</tr>
<tr>
<td>Partial Shipment</td>
<td>7</td>
<td>2%</td>
</tr>
<tr>
<td>Other</td>
<td>2</td>
<td>1%</td>
</tr>
<tr>
<td><strong>Total Discrepancies</strong></td>
<td><strong>554</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Total Discrepant Files</strong></td>
<td><strong>365</strong></td>
<td></td>
</tr>
<tr>
<td>Files Not Examined</td>
<td>22</td>
<td></td>
</tr>
<tr>
<td>Files Examined</td>
<td>343</td>
<td></td>
</tr>
</tbody>
</table>

2.4. Risk Management Techniques and possibility for their application to LC operation

The notion of modern risk management is in an ongoing development from early 1960s, due to changes in global market demand and technology developments. In reference to Sadgrove (Sadgrove, 2005), Pitinanondha comments on three different eras of risk management (Pitinanondha, 2008). Referencing to Pitinanondha’s work shows change in attitudes of businessmen from considering risk as an internal problem to an internal and external issue resulted in changing in risk management techniques from reactive strategies by using insurance to proactive strategies by taking preventive measures. However, as it has been mentioned earlies, scholars strongly criticize literature on Documentary Discrepancy Risk Management in Letter of Credit operation for being limited to the bank’s perspective and neglecting the exporter’s perspective on the issue (Pridotkienė et al., 2006). Therefore, in this section, current research will try to review different risk management models and their applicability to management of risk of documentary discrepancy in Letter of Credit Operation from the perspective of exporter.

COSO Framework

Failure of high profile companies during 1970’s and 1980’s in USA was the result behind formation of Committee of the Sponsoring Organizations of the Treadway Commission in 1985. With primary focus on causes of fraudulent financial reporting, COSO was commissioned to study enterprise wide risk management and governance problems. “Internal Control-Integrated Framework report” was the final outcome of COSO project which was published in 1992. In its final report, with focus on internal control, COSO offers a corporate governance framework at enterprise level in five main areas of controlling environment, risk assessment,
controlling activities information and communication and monitoring (Committee of the Sponsoring Organisations of the Treadway Commission, 1992). However, COSO report admits that internal controls are not sufficient for bad judgments and wrong decisions. COSO framework also received other criticisms for being too much focus on financial reporting and not requiring enterprise to report their internal control process (Root, 1998; Miccolis, Shah, 2000) in conclusion in the context of Letter of Credit Operation, COSO framework is not proper measure to be in place for exporter for managing the risk of documentary discrepancy due to its general and vague nature, not providing any details on implementation method, its focus on financial reporting and excluding risk management from its internal control definitions.

4.1. Development of Enterprise Risk Management Models

In development of risk management techniques, it seems that ERM started to emerge as a concept for managing the enterprise risk in a consistent and comprehensive framework during 1990s (Dickinson, 2001). ERM takes a holistic approach to interconnections among strategic, operational, financial and hazard risks from the perspective of an organization (Scherz, Macaky, 1998). Reason behind emergence of ERM was failure of some high profile companies due to traditional approach of managing risk via “Silo Thinking” as an expression for decision making by

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Fig. 2. Different ages of Risk Management by Pitinanondha (Pitinanondha, 2008)
irrelevant organizational unites and negligence towards overall effect of decisions on the organization as a whole. Below we will study approaches of some ERM techniques to risk management and their applicability to the risk of documentary discrepancy in Letter of Credit Operation.

4.1.1. Integrated Business Management System

In 1999, by following ERM principles, Statzer introduced the Integrated Business Management System (BRMS) (Scherz, Macaky, 1998). However, due to difficulties related to organizational culture and management, he recommends the organizational implementation of BRMS to be commissioned to a third party. BRMS takes a macro level approach to risk management without considering components of the model. In the context of LC transaction, BRMS model completely ignores external and internal contributing factors to the risk of documentary discrepancy which are out of exporter’s control system. As a result, BRMS does not bring significant value to documentary risk management in LC operation for exporter.

Enterprise Risk Measurement

Dickinson argues about the possibility to measure the outcome of firm’s strategy in terms of enterprise risk (Dickinson, 2001). For this purpose, he introduces the external and internal factors which can cause failure for enterprise to achieve its intended goals. According to him, resources, activities and processes are determining elements of strategy which are subject to external (market demand, technology development, industry structure and competition) and internal (human error, fraud, payment systems and bottle neck in production process) factors (Dickinson, 2001). Despite the fact that few elements of Dickinson’s model like human error and payment methods are relevant to documentary discrepancy risk in LC transaction, but model does not provide any detail on aspects of LC operation including bank and country risks. Therefore, Dickinson’s model cannot be useful for exporter to reduce the probability documentary discrepancy in LC transaction.

AZ/NZS 4360 (Australia-New Zealand Risk Measurement Standard of 1995)

AZ/NZS 4360 is the first global risk management standard which was introduced by Standard Australia and Standard New Zealand jointly in 1995. The standard is a “generic framework for identification, analysis, assessment, treatment, and monitoring of risk” (Joint Standards Australia/Standards New Zealand Committee OB/7 on Risk Management, 1995). Standard directly opposes the COSO framework by considering risk management as an integral part of management process. While supporting ERM concept, Standard defines its elements of risk measurement and management as: Establishing the context, identifying the risk, analysing risks, assessment and prioritizing risks, treating risks and finally monitoring and review of the process. Unfortunately, standard elements like risk treatment have only limited application to discrepancy risk inherent to documentation process in LC operation and other risk components like country, bank and customer risks are left unattended. Therefore, it is possible to say that implementation of AZ/NZS 4360
standard will not benefit exporter regarding documentary discrepancy risk in LC operation.

**Updated version of COSO Enterprise Risk Management 2004**
The COSO Enterprise Risk Management Framework was introduced in September 2004 after revision and updating of the Original COSO 1992. Five components of COSO 1992 were increased to eight components in COSO 2004 as following: Assessing internal environment, objective setting, event identification, risk assessment, risk response, information and communication and monitoring (Committee of Sponsoring Organisations of the Treadway Commission, 2004a). COSO 2004 was also accompanied with an application techniques volume which was aimed to facilitate the implementation of framework (Committee of Sponsoring Organisations of the Treadway Commission 2004b). Despite the fact that some elements of COSO 2004 like key external indices might be applicable to LC transaction country economy but, it cannot be useful in terms of managing the risk of documentary discrepancy in LC operation for exporter as COSO 2004 does not have any reference to country risk or bank risk. COSO 2004 has also been criticised for not providing details, too much focus on company objectives, negligence towards allocation of roles, training systems, placing external audit in place and contingency planning (Sadgrove, 2005)

**Australia-New Zealand Risk Management Standard 2004**
Parallel to development of COSO 2004 in the United States, Joint Australia – New Zealand Risk Management Standard was revised which resulted in introduction of AS/NZS4360:2004 (Joint Technical Committee OB-007 Risk Management 2004, Risk management AS/NZS 4360:2004). AS/NZS2004 has been considered by some scholars as “model of clarity. It is brief… complete and refreshingly well written” (Kloman, 2003). In order to make AS/NZS 2004 more effective than its predecessor, some changes were implemented including addition of risk identification process to risk assessment step, replacing strategic and organizational contexts with internal and external contexts in Establishing the Contexts segment and addition of Where, why and when questions to Identifying the Risk Segment. Additionally, within the Risk Analysis segment, identifying the estimating controls replaced determining existing controls, level of risk was determined rather than being estimated and finally, notion of Residual Risk was added to the Treat the Risk segment. AZ/NZS 2004 was criticized for being repetitive and consisting of too many steps (Sadgrove, 2005). AZ/NZS 2004 suggests about sharing the risk as one of the risk management measures and provides contracting and insurance as examples for risk sharing methods. However , in the context of Letter of Credit Operation , as third party organizations which are involved in the process of issuing documents like government organizations and transport companies will never accept liability to discrepancy in documents. Additionally, transport companies have their own terms and condition which in some occasions are subjected to international conventions. Therefore, it is impossible to contract out the risk of discrepancy to the third party as it is argued in AZ/NZS2004. Besides, in LC transaction, issuing banks guarantees
payment to beneficiary in case he tenders complying documents. Therefore, in any condition, beneficiary is responsible for documentary discrepancy as third parties do not have any obligations towards bank. It is only one solution for reducing risk of discrepancy by using contracts which is contracting out documentation process entirely which is possible but not popular. Insurance is another suggestion of AZ/NZS2004 to reduce risk of documentary discrepancy which is possible but very costly.

In conclusion, AZ/NZS2004 provides a very general but effective risk management method at organizational level. However, taking a general approach to risk management prevents it to meet specific necessities of Letter of Credit operation and as a result its implementation for the propose of managing risk of documentary discrepancy in LC operation is not recommended.

**Turnball Framework**
Roberts introduced The Turnball framework in 2005 as another Risk Management Model bases on ERM which links between COSO 2004 and UK Turnbull Report of 1999 (Roberts, 2005) Main principles of Turnball Framework are Risk Identification, Assessment and Response, however, framework just gives general approach to its principles by focusing on internal controls, governance and growing shareholder value without providing any details on implementation methods. Therefore, like many other risk management models which are discussed so far, Turnball Framework will not have justification to be used for managing the risk of documentary discrepancy in Letter of Credit Operation.

**Other Risk Management Models**
Within last two decades, on the basis of Enterprise wide risk management concept, different risk management approaches have been developed. However, many of them suffer from lack of details which reduce effectiveness of such models in practice. ERM is considered to be “systematic and disciplined approach to managing risk throughout the organisation … fundamentally a transformation process that changes the way an organisation perceives and manages risk” (Funston, 2003). Therefore, lack of detailed guidelines results in introduction of simplified methods which will create problems while being linked to decision making process (Ward, 2003). Among others, it is possible to name following risk management models which none of them has any applicability to managing the risk of documentary discrepancy in Letter of Credit Operation: integrated risk management by Association of Insurers and Risk Managers in Commerce (AIRMIC) introduced in 1999; enterprise-wide risk management by DeLoach introduced in 2000; the business risk management process by Hodgkinson introduced in 2001; enterprise-wide risk management by Mottershead and Godfrey introduced in 2001; UK Risk Management Standard, by The Institute of Risk Management, ALARM – The National Forum for Risk Management in the Public Sector and The Association of Insurance and Risk Managers introduced in 2002, and ISO 31000:2009 by The International Standard Organisation (ISO), introduced in June 2009.
The Business Risk Model (McNamee, 2000)

Based on the significant role of internal audit and internal auditor’s position in organizational risk management and in accordance with ERM principles, McNamee introduced the Business Risk Model. In McNamee’s model, risks facing an enterprise are divided into three groups of Ownership, Behavioural and Process Risks (McNamee, 2000). Despite the easy format of model it has the capability to offer a powerful tool for risk management in an organization.

Ownership Risks: According to McNamee, such risks are “associated with acquiring, maintaining, and disposing of all assets, except human assets” (McNamee, David, 2000). Since there is possibility of insuring some of these risks, it is recommended to follow the option of transferring or sharing them in the process of organizational risk management. He further divides ownership risks into four subgroups: A) External Threat: Risk elements which are out of organizational control while being capable of affecting business objectives of the organization. Examples of such risks include: financial market, customer demand, environmental forces like economic and political situation. B) Custodial Risks: Such as damages in the course of storage or transportation and obsolescence of products are risks which are relevant to owning of the product.

C) Hazards: McNamee considers Hazards shared with process risks and define them as risk of loss due to human made disaster, fire or accidental loss. D) Opportunity Costs: Costs of making problematic decision on accusation and disposition of assets (McNamee, 2000). McNamee considers them shards with behavioural risks while providing examples such as: expensive procurement of an asset, disposing an asset in a not proper manner and selling an asset below the market price.

1) Behavioural Risks: Risks “associated with acquiring, maintaining and disposing of human assets” (McNamee, 2000). While McNamee divides them into two groups, he comments on high level of difficulty to manage them. A) Dysfunctional Work Place: Issues like sexual or racial harassment, sabotage, safety and health problem in work place, high level of employee stress which are also connected with process risks. B) Productivity Loss: Problems like poor leadership, lack of discipline and sub-optimal work structure which can result in poor worker commitment.

2) Process Risks: Three groups of risks which are associated with using assets in order to achieve objectives. A) Errors, Omissions and Delays: in the process of business, these risks are random differences of machine or human performance. B) Productivity Loss: Like conflicts in schedules and objectives, problematic control system and process design, wrong working regulations are connected with Dysfunctional Work Places as well as Behavioural Risks. C) Frauds: Including secret commotions, bribery and bid rigging are outcomes of intentional misrepresentation conducted by business partners (McNamee, 2000).
Some of the elements used in the Business Risk Model of McNamee have high level of relevancy to risk of documentary discrepancy in Letter of Credit Operation while some other relevant elements are missing and other elements of model do not have any relevancy to the LC transaction. For example mishandling of documents, fraud, omissions, delays and errors are quiet relevant to documentary discrepancy in LC operation while international trade risks like banking, foreign customers and sovereign risks are missing in the model. Also, Custodial risks, stock obsolescence, opportunity costs and natural hazards which are among main elements of the Business Risk Model do not seem to have any relevant to LC transaction per se.

Therefore, it is possible to conclude that no risk management model designed to deal with documentary discrepancy in Letter of Credit operation. However, the Business Risk Model of McNamee is the model which has been modified by Bergami in the framework of Export Letter of Credit Business Risk Model and adapted to Unified Customs and Practice for Documentary Letter of Credit in order to reduce risk of documentary discrepancy in LC operation (Bergami, 2010).

Export Letter of Credit Business Risk Management (Bergami 2010)
By adapting the Business Risk Management of McNamee 2000, Bergami tries to overcome the problem of absence of risk management model applicable to problem of Documentary Discrepancy in Letter of Credit Documentary Operation (Bergami, 2010). By keeping the same structure of the model, in practice Bergami just replaces ownership risks in McNamee’s framework with Environmental risks and its relevant subsections. As it is clear from Figure 3, Bergami’s Export Letter of Credit Business Risk Model consists of three risk groups including Environmental Risks, Behavioural Risks and Process Risks.

1. Environmental Risks: Consist of four main sub categories of risk including country, customer, and bank risks as well as opportunity costs which are in common with behavioural risks. A noticeable fact regarding environmental risks in LC operation for exporter is existence of possibility to insure them. Therefore, showing reluctance insurance company to insure either of environmental risks in a transaction can be a good sign for exporter to come out to the deal or look for a proper risk management method.

1.A - Customer Risk: Choosing Letter of Credit as a method of payment in international trade is a sign for existence of some problems regarding the customer. Either customer does not have a trading history with exporter or the amount of transaction is too high for credit standing of the customer or payment period in underlying contract is longer that exporter’s expectations. Therefore, exporter requires customer to overcome such risks by providing a Letter of Credit from her bank. Inability of customer to provide the credit in accordance with terms of underlying contract and in timely manner will be a good sign for exporter either to walk away from the deal or require prepayment as the most secure method of payment.
1-B: Country Risk: Exporter is strongly advised to conduct country risk assessment in any single occasion of trade abroad as more than 90% of losses in export trade are estimated to be result of country risk (ONDD, 2008). Different references which are useful in this respect can be OECD’s Country Risk Assessment Model, World Bank’s Doing Business, and reports of Transparency international. Exporter also can use some personalized models to define financial and regulatory risk in the country of destination including: Checklist approach, Delphi Technique, Quantitative Analysis, Inspection visits or combination of above mentioned techniques (Madura, 2006).

1-C: Bank’s Risk: In operation of Documentary Letters of Credit, exporter generally works with issuing bank which is mostly located in applicant’s country and his own bank which is considered as advising bank. By advising credit to beneficiary exporter, advising bank assumes the responsibility of authenticating credit. Otherwise, in case of advising bank’s refrainment to advise the credit, exporter should start doubting about credibility of issuing bank. Beneficiary also can reduce the risk of issuing banks lack of credibility by requiring confirmation of credit by a reputable bank.

1-D: Opportunity Costs: Regarding opportunity costs, Bergami disregards similar elements in McNamee’s Model like asset disposal by considering the irrelevant to LC operation. However, he comments on cost of discounting the credit as a potential risk for exporter (Bergami, 2010)
1- **Behavioural Risks**: Bergami considers three elements under behavioural risk which one of them is common with Environmental Risks and other is in common with Process Risks.

2.A- **Dysfunctional Places**: While McNamee’s indicators of Dysfunctional Places like sexual and behavioural abuse or violent work place do not have direct relations with LC operation, stressful working environment has direct effect on level of documentary discrepancy in LC transaction.

2.B- **Opportunity Costs**: In the context of LC operation, opportunity costs might have origins either in internal documentation process of the exporter’s company or in organizational processes of third party organizations involved in documentation process in the course of LC operation. Unfortunately, all costs of documentary discrepancy should be borne by exporter regardless to who is responsible for it. Therefore, exporter is recommended to prevent such costs by implementation of effective check and balance systems before submission of documents to the bank.

2.C- **Productivity Loss**: Exports should be aware of negative effects of employee’s negligence on documentary discrepancy in LC operation. Therefore, exporter is recommended to apply sound training and audit systems to reduce risk of loss due to low productivity rate of employees which is common with Process Risk elements.

3- **Process Risk**: Bergami defines elements of process risk under six titles while one of them is common with Behavioural Risks while the other one is shared with Environmental Risks.

3.A: **Hazards**: In LC Operation, Hazards can be divided into two main groups of pre-shipment and post-shipment hazards. Pre-shipment Hazards are defined by Bergami as delays in delivery of products to carrier which results in missing the shipping deadline. Post-Shipment Hazards are damages which can happen to the cargo during the shipment or after reaching the destination when exporter is using delivery terms from Incoterms. Obtaining sufficient insurance policy is a recommended risk management method for such risks.

3.B: **Errors, Omissions and Delays**: Bergami relates such risks to documents of trade of trade and comments on such risk as outcome of organizational problem in exporter’s company or their party issuer of documents. Errors are mistaken data used in preparation of documents. It is easy to correct them when errors are result of in-house processes of exporter’s company, but when they are outcomes of third party mistakes, correction might be costly and time consuming. Omissions are missing data from documents which are easy be fixed in case documents are prepared by exporter’s organization, but third party documents are generally difficult to be fixed. Delays can be due to organizational negligence of exporter in on time delivery of goods and documents or involvement of external factors like
delay of vessel during lauding and shipment process. In either conditions, delay can be a serious risk for exporter (Bergami, 2011).

3.C: Fraud: Risk of fraud has been considered to be either result of false sales and shipping or misrepresentation of documents by unscrupulous exporter to the bank (Lister, Linda, M., 2007). Fraud in underlying contract or false sales and shipment will not affect the LC operation as principle of Independence separates the credit from its underlying contract. However, presentation of fraudulent documents can be a source of risk for exporter which can result in not payment of credit to him. Therefore, exporter is recommended to pay sufficient attention to authenticity of documents particularly third party documents and establish authenticity of all documents before submission of them to the bank.

3-D: Productivity Loss: In the context of the Business Risk Management Model, McNamee considers wrong working regulations and lack of control as examples of productivity loss (McNamee, 2000). However, in adapting the Business Risk Management Model to LC transaction, Bergami considers allocated resources to correction of discrepant documents as example of productivity loss. Bergami also refers to result of 2001/02 survey of SITPRO Ltd in UK which defines the cost of exporters to correct documentary discrepancies at the annual level of £113 Million (Bergami, 2011). Further, Bergami considers exporter’s loss of not being paid by bank due to documentary discrepancy in the same category of productivity loss. Bergami comments on effectiveness of Letter of Credit Business Risk Management in managing risk of documentary discrepancy in LC based on the evidence from his research on Risk Management of Australian Exports to ASEAN via Documentary Letter of Credits (Bergami, 2011).

3. Conclusion

Documentary Letters of Credit are used in international trade in order to reduce the inherent risks of trade for exporters and importers. However, among other trade related risks for exporter, application of fundamental principle of Strict Compliance to LC operation which prevents effectuating of payment to beneficiary exporter in case of presenting discrepant documents to the bank as a source of risk for exporter. Since documentation process is not fully under the control or Exporter and some documents like insurance, transport and governmental documents are produced by third party organizations, exporter has no other choice rather than finding a solution to manage the risk of documentary discrepancy in LC operation in order to receive his payment on time. By studying different risk management methods and applicability of present ERM techniques to LC operation, current research tried to find an answer to the question of which risk management method can be used for the purpose of managing the risk of documentary discrepancy in LC transaction. Findings of the research supports absence of specific risk management technique among different ERM methods which can be applied to problem of documentary
discrepancy in LC operation. The only exiting method is Export Letter of Credit Business Risk Model of Begami which is adopted from Business Risk Model of McNamee 2000, however, its effectiveness is need of further research.

References


framework, American Institute of Certified Public Accountants, Durham, NC, USA.


6.4. FRAUD IN DOCUMENTARY LETTERS OF CREDIT, COMPARATIVE STUDY OF EXISTING INTERNATIONAL LEGAL FRAMEWORK

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Abstract

Documentary letters of credit are among most popular trade finance instruments used in international business. Despite the fact that main purpose derived from application of documentary letters of credit is to reduce the risk of trade, their mere documentary nature makes them vulnerable to the problem fraud. There is a huge interest among legal scholars and academicians to analyse the nature of fraud in documentary letters of credit due to its important financial effect on smooth process of international trade and also diversified approach of different legal systems to this particular problem. However, majority of conducted studies are limited to most popular legal systems including British and American law. However, need for studying the LC fraud in a comprehensive comparative manner among existing international legal frameworks is well noticed for long time. Due to their international nature, LC operation is subjected to substantial number of legal frameworks which most of them are either taking a silent position towards problem of fraud or do not show uniform approach to the same problem. In this paper, author tries to study different sources of law in documentary letters of credit and their approach to the problem of fraud in a comparative manner. The main research question which current paper is trying to answer is what is the position of fraud rule in applicable legal frameworks to the international LC operation and how do they approach the problem of fraud committed by beneficiary in documentary letters of credit?

For this purpose, paper is divided into four main parts: After the introduction, second part will discuss the sources of law applicable to international LC transaction. Third section will analyse the legal nature of fraud in LC transaction. Fourth section will scrutinize the legal approach of different legal frameworks to fraud in documentary letters of credit and finally, the last section will sum up the discussion with concluding remarks.

1. Introduction

Documentary letters of credit are among most popular trade finance instruments used in international trade. They are also known as “Life bold of international commerce”.

In the simple documentary letters of credit, an importer buyer approaches a bank of good reputational to open an irrevocable letter of credit in favour of exporter to cover the cost of goods or services covered in the underlying contract between parties. In this way, risk of payment from buyer will be transferred to a bank with much stronger financial standing. The credit will be advised to the exporter and in case of his agreement with terms and conditions of the credit, it will be issued in his favour. Exporter will ship the goods to importer and present complying documents to terms and conditions of

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7 Harbottle (RD) (Mercantile) Ltd v National Westminster Bank Ltd [1978] 1 QB 146
the credit to bank. The bank will honour seller’s presentation after examination of documents presented by seller and making sure about their strict compliance with the credit. As a result, it is possible to mention that three main parties are involved in operation of commercial documentary letters of credit: importer, exporter and issuing bank. However, due to long distance between buyer and sellers in international commercial transaction, other parties will eventually become involved in operation of documentary letters of credit. Such parties can play the role of advising bank, confirming bank, nominated bank and reimbursing bank. The development of law and practice of documentary letters of credit has been subject to customs of international trade as evolved in the course of time. Despite the fact that main purpose derived from application of documentary letters of credit in practice of international trade finance is to reduce the risk of trade, their mere documentary nature makes them vulnerable to the problem of fraud. This is evident from “a huge volume of case law concerning the issue of fraud has grown up. Legal writing on this topic is no less voluminous.” There is a huge interest among legal scholars and academicians to analyse the nature of fraud in documentary letters of credit due to its important financial effect on smooth process of international trade and also diversified approach of different legal systems to this particular problem. Fraud in documentary letters of credit is even considered as “the most controversial and confused area” because it “goes to the heart” of letter of credit operation. Situation will become even more complicated when it becomes clear that due to international nature of LC operation, they are subjected to substantial number of legal frameworks which most of them are either taking a silent position towards problem of fraud or do not show uniform approach to the same problem. United States of America is the only country which has statutory law which recognizes the fraud in documentary letters of credit. Article 5-109 of the revised Uniform Commercial Code provides a detailed legal position of LC fraud in American legal system. In England, LC fraud is subject to principles of common law system embodied in substantial body of case law on the subject matter. Other existing legal frameworks applicable to international operation of documentary letters of credit have more international nature and either introduced by International Chamber of Commerce or UNCITRAL. ICC has introduced Uniform Customs and Practices for Documentary Letters of Credit (UCP), Uniform Rules for Demand Guarantees (URDG), Uniform Rules for Contract Guarantees (URCG)

10 KOZLCHYK. Boris, Letters of Credit, INT'L ENCYCLOPAEDIA OF COMPARATIVE LAW 1979, 10 .
International Standby Practices (ISP 98). UNCITRAL has introduced United Nations Convention on Independent Guarantees and Standby Letters of Credit (the Convention) on 1995.\textsuperscript{15}

In this paper, author tries to study different sources of law in documentary letters of credit and their approach to the problem of fraud in a comparative manner. The main research question which current paper is trying to answer is what is the position of fraud rule in applicable legal frameworks to the international LC operation and how do they approach the problem of documentary fraud in documentary letters of credit?

For this purpose, paper is divided into four main parts: After the introduction, second part will discuss the sources of law applicable to international LC transaction. Third section will analyse the legal nature of fraud in LC transaction. Fourth section will scrutinize the legal approach of different legal frameworks to fraud in documentary letters of credit and finally, the last section will sum up the discussion with concluding remarks.

2. Sources of Letter of Credit Law

In the course of history, development of law and regulations of the Documentary Letter of Credit was based on custom. However, in modern time; International Chamber of commerce has provided the major source of law for documentary letters of by assuming the responsibility for codification of relevant customs and usage under Unified Custom and Practices for Documentary Credits (UCP). Additional to UCP, International Chamber of Commerce has introduced other regulations including eUCP, Uniform Rules of Contract Guarantees, Uniform Rules for Demand Guarantees, ISP98, which is International Standby Practices for Independent Guarantees and Standby Documentary Credits. United Nations Conference for International Trade Law also individually took the initiative to prepare universal regulations for Independent Guarantees and Standby Letters of Credits which is known as UNCITRAL Convention. Despite existence of many international frame works for regulation of documentary credits, this issue has been addressed in few national law systems. Among Civil Law countries only Colombia, El Salvador, Greece, Guatemala, Honduras, Lebanon, Mexico, and Syria have statutory rules on the letter of credit; and, the only country in the common law system is the United States. In other Common Law Countries including England, Legal issues of documentary credits are subjected to case law.

The main focus of current paper in this section will be study of different International legal sources for documentary credits, and also the answer of common law system to the question of legal framework for documentary credits.\textsuperscript{15}

3. **Principle of autonomy and fraud rule**

3.1 **Principle of Autonomy**

Alongside with principle of strict compliance in operation of letters of credit and cornerstone of current article is Principle of Autonomy. Independence principle has been recognised and appreciated in national and international law. The principle of autonomy of letters of credit has been considered as “the engine behind the letter of credit”, and “cornerstone of the commercial validity of the letters of credit”. Principle of Independence has been clearly mentioned in Article 4 of UCP 600:

“Article 4 Credits v. Contracts
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.”

According to Article 4 of the UCP 600 and by referring to principle of independence, the beneficiary exporter receives the guarantee that he will be paid after tendering the complying presentation of documents to the issuing bank. Neither bank nor the account party will be able to withhold payment with relevant arguments to the quality of delivered goods or other issues related to performance of underlying contract. Therefore, even in cases of conflict on performance of underlying contract account party and issuing bank have no other choice rather than paying beneficiary upon presentation of complying documents and seek remedy by suing him for the breach of underlying contract. As a result, Autonomy Principle has been considered a means of promoting international trade by following the logic of “pay first, argue later”.

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

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16 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
In order to completely address the essence of 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.”

3.1.1. Principle of Autonomy and Common Law Position

The principle of autonomy has been recognized in many common law cases. Particularly, the importance of autonomy principle has been recognized by Lord Diplock in *United City merchants (Investment) Ltd v Royal Bank of Canada*.

“The whole commercial purpose for which the system of confirmed irrevocable documentary credits has been developed in international trade is to give to the seller an assured right to be paid before he parts with control of the goods that does not permit of any dispute with the buyer as to the performance of the contract of sale being used as a ground for non-payment or reduction or deferral of payment”

*Trans Trust SPRL v Danubian Co Ltd* is other English case which raise the importance of autonomy principle when Denning LJ refers to necessity for seller to finance his own suppliers and as a result relies on provided LC by buyer for honouring his own account payables to the third party.

American Case law also illustrates the importance of autonomy principle. For example in *Semtex Corporation v UBAF Arab American Bank*, US District court granted Semtex a summary Judgement against the UBAF on the basis of autonomy principle of Irrevocable Letters of Credit despite the fact that underlying contract was not performed due to the Executive Order which blocked all Iraqi assets in USA after Iraqi invasion to Kuwait on August 2, 1990. *Power Curber International Ltd v. National Bank of Kuwait SAK* is another case which prohibits applicant and issuing bank from dishonouring the credit based on non performance of the underlying contract.

Uniform Commercial Code of USA

In United States of America, Documentary Letters of Credit are governed by Article 5 of Uniform Commerical Code. Unlike earlier version of Article 5 of UCC did not point at the autonomy principle revised vesion of UCC Article 5

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21 UCP600. Article 5
23 United City Merchants (Investments) Ltd v Royal Bank Of Canada [1983] 1AC 168,183
24 *Trans Trust SPRL v Danubian Co Ltd* [1995] 2QB 297 at 304
25 [1995] 2Bank LR 73

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clearly separates the undertaking of issuer in documentary letter of credit from existence, non-existence, performance or non-performance of underlying contract.

‘the rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or non-performance of the contract or arrangement out of which the letter of credit arises or which underlie it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary’

‘an issuer is not responsible for the performance ,non-performance of the underlying contract, arrangement, or transaction’

3.1.2. Exceptions to the Autonomy Principle

The autonomy principle provides beneficiary with the guarantee of the bank for payment against any issue within of the terms of documentary Credits. Such guarantee desires payment to the beneficiary regardless to any dispute on the underlying contract, upon tender of complying documents. Therefore, the autonomy principle creates a weaker position for account party against abusive demands of beneficiary and his fraudulent claims. On such occasions, relying on strict compliance principle and rejection of non-complying documents by bank will be the only defence of applicant. However, this defence might not work when the beneficiary is determined to obtain payment on the basis of presenting fraudulent Documents. On the other hand, the beneficiary has the upper hand against the issuing bank and account party in which regardless to any dispute on the contract of sales, he is entitled for payment upon tender of complying documents. Such upper hand can be an incentive for abusive demand for payment or presentation of fraudulent documents by beneficiary. For a long period of time the general belief was supportive towards the absolute nature of independent principle. However, it became clear that exceptions are needed to deal with abusive and fraudulent demands. As result, the fraud exception has been established which is recognized by all common law and many civil law countries. In cases of fraud, court has the obligation to decide between respecting the principle of autonomy and grating injunction to stop payment after considering public policy, statutes, public interest and third party rights. Despite the fact that Fraud rule is a recognized expectation to principle of autonomy of documentary credits, but there is no standard regarding

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28 UCC. Article 5-103(d)
29 UCC. Article 5-108(d)(1)
30 ENONCHONG, Nelson . The independence principle of letters of credit and demand guarantees. Oxford University Press, 2011, 93
31 United City Cooperation v. Allied Arab Bank (1985) 2 Lloyds Rep. 554,561
time and circumstances in which it should supersede the autonomy principle. Later it became clear that exercising the public interest requires application of exceptions in case of illegal underlying contract. Therefore, clear evidences show that English Legal system is ready to recognize other exceptions in to the principle of autonomy.

3.2. Fraud Exception

In fact, Fraud is very old and well-known phenomenon in the business world. “As long as there have been commercial systems in place there have been those who have tried to manipulate these systems.” Fraud has been considered as the “the most controversial and confused area” as it “goes to the very heart” of the letter of credit by providing the bank to look at the facts behind complying presentation of beneficiary and stop payment in cases of fraud in transaction.

4. Legal Approach to LC Fraud Exception

4.1. The American View

In this section, American approach to LC fraud will be reviewed. In doing so, principle case of Sztejn v. J. Henry Schroder will be studied. Sztejn case is known for laying the foundation of LC fraud exception in the United States of American and also in England. Further, Article 5-109 of Unified Commercial Code as statutory body of law which regulates Fraud in LC operation in the United States and grant of injunction as a judiciary remedy to fraud will be analysed.

4.1.1. Sztejn v. J. Henry Schroder banking Corporation

This is the leading case on fraud rule in the United States of America that seriously affected the development of fraud exception in documentary letters of credit. Another importance of Sztejn case is being a reference in the process of codification of 1962 version of UCC as well as being the principle authority for latter cases on

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36 Trade Finance Fraud –Understanding the Threats and reducing the Risk, A Special Report prepared by the ICC International Maritime Bureau (Paris) 2002, p. 9
38 Gao X & Buckley RP (2003), p. 293
39 (1941) 31 N.Y. S.2d 631.
fraud in LC operation. Gao refer to Sztejn case as “it shaped the fraud rule in virtually all jurisdictions”.

In this case, based on the international contract of sale between Sztejn (the buyer) and Transea Traders Ltd (the Seller), documentary letter of credit issued by Schroder (the issuing bank) as the method of payment with the draft drawn by issuing bank on the Chartered bank (presenting bank). Before presentation of documents to the bank, applicant (Sztejn) demanded court for granting injunction against beneficiary based on receiving “cow hair, other worthless material and rubbish with intent to simulate genuine merchandise and defraud the plaintiff” Szetjn also named Chartered bank as collecting bank not the holder in due course of the draft issued by issuing bank. Justice Sheintag of the New York Court of Appeal considered all allegations in case as truth and rejected to motion of Chartered Bank to dismiss the compliant of Szetjn on the basis of two arguments: allegation and established fact of fraud being committed within the framework of underlying contract. His statement started as following:

“It is well established that a letter of credit is independent of the primary contract of sale between the buyer and the seller. The issuing bank agrees to pay upon presentation of documents, not goods. This rule is necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade”.

And continued on necessity to overrule the principle of independence in case of committing fraud by beneficiary:

“Of course, the application of this doctrine [the principle of independence] presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit.

However, I believe that a different situation is presented in the instant actions. This is not a controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller’s fraud had been called to the bank’s attention before the drafts and documents have been presented for payment, the principle of the independence of the bank’s obligation tinder the letter of credit should not be extended to protect the unscrupulous seller... Although our courts have used broad language to the effect that a letter of credit is independent of the primary contract between

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41 In 1964 version of UUC fraud rule was under Article 5 section 5-114 but after revision of 1995 it is under Article 5, section 5-109
42 KELLY-LOUW, Michele, Selective legal aspects of bank demand guarantees (Doctoral dissertation).2009, 179
43 31 NYS 2d 631 (1941) 633
44 Ibid 632
the buyer and seller, that language was used in cases concerning alleged breaches of warranty; no case has been brought to my attention on this point involving intentional fraud on the part of the seller which was brought to the bank’s notice with the request what it withhold payment of the draft on this account”45

Court dismissed the motion of Chartered Bank against complaint of plaintiff and granted injunction to Szetjn:

“This Transea was engaged in a scheme to defraud the plaintiff..., that the merchandise shipped by Transea is worthless rubbish and that Chartered Bank is not an innocent holder of the draft for value but is merely attempting to procure payment of the draft for Transea’s account”46

The case of Sztejn is also important for recognizing the immunity of the holder in due course as well as bank security as a supporting reason in application of fraud exception:

“While the primary factor in the issuance of the letter of credit is the credit standing of the buyer, the security afforded by the merchandise is also taken into account. In fact, the letter of credit requires a bill of lading made out to the order of the bank and not the buyer. Although the bank is not interested in the exact detailed performance of the sales contract, it is vitally interested in assuring itself that there are some goods represented by the documents”.47

“On this motion only the complaint is before me and I am bound by its allegation that the Chartered Bank is not a holder in due course but is a mere agent for collection for the account of the seller charged with fraud. Therefore, the Chartered Bank’s motion to dismiss the complaint must be denied, if it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud.”48

4.1.2. Article 5 of the Unified Commercial Code

Article 5 of the Unified Commercial Code is governing the operation of Documentary Letters of Credits besides Case Law in the United States of America. The UCC had a permanent editorial board which published commentaries which

45 Ibid .633
46 Ibid
47 Ibid , 634-635
48 Ibid
are often cited by judges as an authority for explanation of different provisions\textsuperscript{49}. Article 5 of the current version of UCC is fully allocated to Documentary Letters of Credit. Drafting committee was following the goal of finding a way for further harmonization of US law with international regulations besides flexibility in practice to meet technological changes and keep the competitive position of LC in international trade. Article 5 of the UCC also contains relevant provisions in LC fraud exception\textsuperscript{50}.

Current Article 5-109 is titled “Fraud and Forgery” covers circumstances necessary for granting interlocutory injunction the text of article such circumstances as following:

“(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honour of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant: (1) the issuer shall honour the presentation, if honour is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honoured its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer’s or nominated person’s deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and (2) the issuer, acting in good faith, may honour or dishonour the presentation in any other case.

(b) If an applicant claims that a required document is forged or materially fraudulent or that honour of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honouring a presentation or grant similar relief against the issuer or other persons only if the court finds that: (1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer; (2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted; (3) all of the conditions to entitle a person to the relief under the law of this State have been met; and (4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honour does not qualify for protection under subsection (a) (1).”

\textsuperscript{49} ZHANG, Yanan. Approaches to Resolving the International Documentary Letters of Credit Fraud Issue. Doctoral Dissertation University of Eastern Finland, 2011, p 74

\textsuperscript{50} UCC, Article 5 -109
Text of UCC article 5-109 follows two main directions of “fraud immunisation” and “fraud exception”51. An important aspect of Article 5-109 (a) is clarification of the fact that fraud is applicable both to forgery in documents stipulated in the Credit and in underlying sales contract. Article also comments on necessity of fraud to be material in order to issue injunctive relief. However, it does not define what does it mean for fraud to be material? Whereby, official comment on the Article provides: “the beneficiary has no colourable (meaningful) right to expect honour and where there is no basis in fact to support such a right to honour”52.

Neither text of article 5-109 nor its official commentary refer to intention of beneficiary to defraud. As a result, it has been argued that UCC article 5-109 has focus on seriousness of fraud in the course of transaction not beneficiary’s intention and state of mind53. It is clear from the official commentary that standard of proof for fraud is set high and mere allegation of fraud is not sufficient for granting injunction to applicant54. Injunction will be granted only after meeting high standard of proof for the purpose of preventing threats to independence principle in LC operation. Commentary also stipulates that granting similar reliefs like attachment and declaratory judgement by court should follow similar high standards55. Attachment is a sort of preliminary relief to secure or seize the disputed property following the objective to force compliance with court decision on pending case56. Declaratory Judgement refers to court judgement in determining the rights of parties under, a statute, a contract or a will, on the basis of any fact or law.

Scholars consider the US approach to fraud in documentary letters of credit as “unduly narrow approach”57 which limits the application of LC fraud exception58. Different interpretations of judges from standard of proof are also a discouraging factor59. This can be a disadvantage for American law to show different interpretations of judges from a single problem in presence of uniform standard of “material fraud”60.

52 UCC Article 5 Letters of Credit, UCC §5-109 Forgery and Fraud, Official Comment 1.
54 UCC Article 5 Letters of Credit, UCC §5-109 Forgery and Fraud, Official Comment 4.
55 Ibid
4.2. English Law

Under English Law, Documentary Letters of Credit are considered as the life blood of the commerce as it affects the independence principle in international operation of LC. Historically, English courts take a restrictive approach in interfering in obligation of bank to pay unless there is a corroborate evidence of committing fraud by beneficiary. Even nullity and illegality of underlying sales contract does not affect the court decision to interrupt the regular operation of LC by issuing stop order payment to bank. Unlike American law, there is no statute regulating LC fraud rules in England and this area of law has been consistently governed by case law from late 1970s till today.

English law does not have any definition for fraud and court should conclude its establishment on the case to case basis. However, according to existing authorities, there are four main types of LC fraud disputes distinguished in English Law. First, beneficiary sues the bank on the basis of bank’s rejection to pay despite receiving compliant presentation. Second, Bank has payed beneficiary, however, sues beneficiary due to presentation of fraudulent documents and request for restitution of the payment. Third, paying bank sues the issuing bank in request for reimbursement after effectuating the payment, and refusal of issuing bank to reimburse on the basis of fraud. Finally, before effectuating the payment by bank, applicant request interlocutory injunction from court to stop bank from payment on the basis of beneficiary’s fraud.

In similar way to American Law, it seems that under English law injunction is the most popular legal relief sought by applicant against either bank or beneficiary in cases of LC fraud. However, restrictive approach of English courts to interfere in independence principle of Documentary Letters of Credit creates doubt in usefulness of such remedy. This section explores non harmonious approach of English courts to different types of LC fraud disputes with special focus on procedural aspects of interlocutory injunction in England.

4.2.1. Bank’s rejection to pay

Upon presentation of confirming documents by beneficiary, issuing bank and conforming bank if any has the duty to honour the presentation. In case of bank’s decision not to effect the payment to beneficiary, it should prove the

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63 D’ARCY, Leo, Schmitthoff’s Export Trade - The law and Practice of International Trade, London: Sweet & Maxwell, 2000,10th ed, p. 166
65 Ibid .264
establishment of fraud based on existing standard of proof introduced by English Courts66 (discussed in injunction chapter of current paper). However, it is rare that the bank refuses to honour the credit on its own initiative67. Banks generally do not reveal fraud and the information and instructions about fraud come from account party. After receiving allegation of fraud from account party, bank has the option to pay or not. In case it decides to effect the payment, obtaining the injection from court will be the only solution for account party to prevent payment to beneficiary68. If bank decides not to pay, then either beneficiary’s fraud is established and bank will be excused from payment or if otherwise happened, bank will be in breach of contract. When bank decides not to effect the payment, beneficiary might apply for summary judgement against the bank in order to get quick remedy without going to full trial69. Issuing the summary judgement by court in England is subjected to the English Civil Procedural Rules (CPR) . Part 24.2. Accordingly:

“The court may give summary judgment against a claimant or defendant on the whole of a claim or on a particular issue if – it considers that :(i) that claimant has no real prospect of succeeding on the claim or issue; or (ii) that defendant has no real prospect of successfully defending the claim or issue; and There is no other compelling reason why the case or issue should be disposed of at a trial”70.

The decision of courts in Solo Industries v Canara Bank71, Safa Ltd v Banque du Caire72 and Banque Saudi Fransi v Lear Siegler Services Inc73 show that in case of beneficiary’s application for summary judgement, bank is subjected to a higher standard than what is required in CPR 24.2. Therefore, for court, it is not sufficient that bank can show a real prospect of successfully establishing fraud in its defence. In addition, bank is required to prove the real established fraud “which has the capability of being clearly established at the interlocutory stage”74. In occasions that bank does not resist payment on the basis of fraud rule like refraining to pay based on invalidity of letter of credit, it would be sufficient to satisfy the normal standard75 while trying to show the real prospect of success under CPR 24.2.

66 Ibid
68 Ibid
69 Ibid
71 Solo Industries UK Ltd v Canara Bank [2001] 1 WLR 1800
72 Safa Ltd v Banque du Caire [2000] 2 Lloyd’s Rep.600
73 Banque Saudi Fransi v Lear Siegler Services Inc. [2007] 2 Lloyd’s Rep 47
74 Ibid , 31-32
75 Ibid 33
4.2.2. Bank’s Entitlement for Reimbursement

General rule is that the bank which has paid against conforming presentation is entitled for reimbursement. However, in case of fraud, bank has no obligation against beneficiary or entitlement against the account party to effect the payment. In case of payment in such circumstances, bank cannot claim for reimbursement. However, the bank which does not have information about the fraud of beneficiary will not be prejudiced.

In the case of Angelica-Whitewear Ltd v Bank of Nova Scotia, which was referenced by English courts, Le Dien J. from the Supreme court of Canada argued that it case of improperly paid draft by issuing bank the standard of proof for fraud should be set in the question that “Whether fraud was so established to the knowledge of issuing bank before payment of the draft as to make the fraud clear or obvious to the bank.” According to Le Dien J, standard of proof for such cases was different from standard of proof when applicant is trying to obtain interlocutory injunction against bank to restrain the payment to the beneficiary. He explained that in latter case the “strong prima facie test will apply.”

As it was discussed before, it can be understood that the bank which is trying to resist summary judgement against the payment to beneficiary is subjected to the higher standard of proof. However, this does not apply in the occasion that applicant, issuing bank or confirming bank try to resist the summary judgment as a result of being sued for reimbursement by the bank which has paid the fraudulent beneficiary. In such occasions, defendant is expected to provide a real prospect of existing fraud and satisfy the normal test of CRP Part 24.2 at trial.

In case of Banque Saudi Fransi v Lear Siegler Inc, the issuer of a performance bond was seeking for summary judgement against the instructing party who provided a counter indemnity. After making the payment to the beneficiary defendant, issuing bank raised the defence of not being bound for payment under the country indemnity due to dishonest claim of the beneficiary. In trial, defendant managed to successfully resist against the summary judgement by showing the real prospect which was clearly established. In the above decision, it is implied that although, beneficiary might successfully obtain the summary judgement against bank as a result of bank’s failure to establish a clear evidence of fraud, there is no guarantee that bank can in return obtain summary judgement for

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76 ELLINGER, P, NOE. D, (2010), 147
78 Ibid, 59, 84
79 Ibid
80 ELLINGER, P, NOE. D, (2010), 147
81 Ibid
82 Banque Saudi Fransi v Lear Siegler Services Inc. [2007] 2 Lloyd’s Rep 47, 18
83 Ibid
receiving reimbursement against the instructing party. Because the instructing party should only meet requirements of the low test of real prospect of fraud in the trial. 

4.2.3. Fraud in deferred payment obligations

Under the deferred payment credits, the nominated bank has the obligation to pay on the maturity date in accordance with the credit terms. As under deferred payment system there is no immediate payment available to seller till the date of maturity of credit, the seller is responsible to ship goods and expects payment on maturity. Such process will impose financial burden on seller. Therefore, market demand in similar conditions resulted in creation of forfaiting practice. In forfaiting practice, nominated bank may agree to discount the beneficiary’s documents and expect reimbursement from issuing bank on maturity date. In case of beneficiary’s fraud before the maturity date, applicant and issuing bank will definitely try not to reimburse the nominated bank which has paid to fraudulent beneficiary. Despite the fact that establishment of beneficiary’s fraud will depend in facts of each individual case and in addition guideline for interbank reimbursements under differed payment is provided by UCP 600, it worth to review the right and obligations of involved financial institutions under deferred payment before and after coming into force of the UCP 600.

4.2.4. The standard of proof

When account party is looking for injunction to prevent beneficiary from demanding payment or bank from enforcing payment on the basis of fraud exception, the first necessary step to take is meeting the standard of proof. In the case of United City Merchants (Investment) Ltd v Royal Bank of Canada, the standard of proof for fraud was considered when Lord Diplock held the requirement as “Clear, obvious, or established fraud known to the issuer or confirmer of the letter of credit.” Also Ackner LJ, in the case of United Trading Corp. SA v Allied Arab Bank Ltd laid down the standard of “only realistic inference” in order to provide an alternative to the “clear evidence” provided by Lord Diplock in United City Merchants. Ackner LJ further emphasized that:

“The evidence of fraud must be clear, both as to the fact of the fraud and as to the [guarantor’s] knowledge. The mere assertion or allegation of fraud would not be

84 Ibid
86 United Trading Corp. SA v Allied Arab Bank Ltd, [1985] 2 Lloyds Rep 554, 561
87 Ibid
88 United Trading Corp. SA v Allied Arab Bank Ltd, [1985] 2 Lloyds Rep 554, 561
sufficient...We would expect the court to require a strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly those emanating from the buyer.\textsuperscript{89}

Court also commented:
“for the evidence of fraud to be clear, it would be expected that the buyer was given the necessary opportunity to answer the allegation against him and he (buyer) fails to provide any, or any adequate answer in circumstances where one could properly be expected. If the court considers that on the material before it the only realistic inference\textsuperscript{90}

Other similar positon was taken by Mance LJ in The Court of Appeal of Solo Industries UK Ltd v. Canara Bank\textsuperscript{91}. Mance LJ while responding to the contention of bank towards standard of proof which should preclude “any possibility of innocent explanation” took as very close position to the position of United Trading Corp. SA. From what has been discussed so far, it can be clearly understood that standard of proof for fraud under English law has been formulated differently. One reason can be that courts try to set not too high standard from one hand to safeguard the autonomy principle and on the other hand set it too high not to be attainable in practice. As a result, there are different standards of proof including “established or obvious fraud”\textsuperscript{92}, “good arguable case which is the realistic inference on the material available for beneficiary to be fraudulent”\textsuperscript{93} or the “real prospect”\textsuperscript{94} of establishing fraud.

As it was mentioned earlier, the second step for obtaining the injunction is satisfying the balance of convenience.

The issue was not always considered in English court’s decision while deciding to grant injunction base on fraud. One reason is that in most cases evidence was not enough to establish fraud and as a result the case did not proceed to the stage for considering the balance of convenience.\textsuperscript{95} Therefore, when claimant manages to establish the basis for injunction, court will consider the balance of convenience in order to issue the injunction.\textsuperscript{96} it has been mentioned that in the context of injunctions to prevent either beneficiary from claiming the payment or bank form effecting the payment in most cases balance of convenience is against granting the injunction.

\textsuperscript{89} Ibid
\textsuperscript{90} Ibid
\textsuperscript{91} Solo Industries v Canara Bank [2001] 2 Lloyd’s Rep 578.
\textsuperscript{92} Edward Owen Engineering Ltd v. Barclays Bank International [1978]QB 159, per Lord Denning
\textsuperscript{93} United Trading Corporation SA v. Allied Arab Bank at FN 27 per Ackner LJ at 561
\textsuperscript{94} Solo Industries UK Ltd v Canara Bank [2001] 1 WLR 1800, [2001]EWCA Civ 1059
\textsuperscript{95} ENONCHONG (2011) 158
\textsuperscript{96} ENONCHONG (2011) 236
The main reasons against granting injunction can be named as resistance of adequate remedies for damages, imminent expiry date of credit, availability of freezing injunction and availability of final accounting between parties.  

4.3. UCP’s view

The Unified Customs and Practices for Documentary Letters of Credit (currently UCP 600) were published by ICC for the first time in 1933. UCP is considered as one the most successful private initiatives in regulating international trade practice. Article 5 of the UCP has recognized the principle of autonomy in LC transaction by emphasizing that bank deals with documents not goods and liability of bank is limited to pay to beneficiary against presentation of complying documents. However, it takes an absolute silent position towards fraud and leaves it open for national laws. To justify their approach, ICC authorities point at different ways to address the problem of abusive demand and fraud in different jurisdictions and consider protection of parties in good faith as responsibility of national courts. Many scholars confirm the sensitivity of fraud and different approaches of national jurisdictions to it by considering the silent approach of UCP to fraud exception as a ground-breaking success. They argue that current approach of UCP to fraud encourages national courts to deal with this problem with no negative effect on the market position of Documentary Letters of Credit as popular trade finance tool in international trade.

In the same vein, Goode comments: “the content and explanation of ICC Uniform Rules are influenced by the fact that these uniform rules are rules of best banking practice, not the rules of law…” while fraud is “the province of the applicable law of the courts of the forum”. This would convey the meaning that despite recognition of the problem of fraud by drafters of UCP, they have intentionally set it aside.

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97 Ibid
98 UCP 600, Article 5
102 Ibid
Leacock considers UCP approach to LC fraud as “unqualified liability”\textsuperscript{106}. He further explains that with reference to independent principle, paying bank does not have any liability to beneficiary’s fraud in case of paying against confirming documents even after receiving notice from applicant\textsuperscript{107}.

However, UCP’s silent approach to fraud has been criticized by other scholars on the basis that regulations should provide secure and predictable environment for trading partners, where different approaches of national laws to fraud is unsatisfactory as there is not provide certainty for businessmen who intend to enter international trade\textsuperscript{108}. Inclusion of fraud rule in UCP is one of the recommend solutions for non-harmonized approaches of national laws to this problem\textsuperscript{109}. Drafting a set of transnational trade law with special focus on non-harmonized aspects of international LC operation including fraud is another scholarly proposal\textsuperscript{110} which does not seem realistic due to time consuming process of ratification of such draft by different nations\textsuperscript{111}. In brief, fraud exception is excluded from UCP and left under the discretion of national law. This approach of ICC has been denounced by some scholars who consider it as a reason for uncertainty in international trade while others call it as successful step towards increasing international marketability of Documentary Letters of Credit\textsuperscript{112}.

4.3.1. UCP

“This is the acronym for the supplement to the uniform Customs and Practice for Documentary Credits for Electronic Presentation”\textsuperscript{113}. Meeting the needs for electronic trade was the initiative of Banking Commotion of ICC to propose the formation of committee to work on developing a bridge between UCP and processing the electronic equivalent of paper based credits the working group started to work on preparation of a supplement to the UCP which “would deal with the issues of Electronic Presentation”\textsuperscript{114}. The result of working group’s efforts is known as eUCP. It came into force from 1 April 2002 and in the format of version issues in order to facilitate the necessities for further revisions\textsuperscript{115}. Current version of eUCP is the version 1.1. Issues covered by eUCP are: “eUCP- UCP

\begin{thebibliography}{99}
\bibitem{107} Ibid.913
\bibitem{110} ROWE, M, ‘Do We Need a Transnational Law on Documentary Credits? Michael Rowe & Bernard Wheble Debate’, DCI (ICC), 1998, Spring, Vol. 4, No. 2, pp. 16-17.
\bibitem{111} Ibid
\bibitem{112} BUCKLEY, Ross P. & GAO, Xiang 2002. 676
\bibitem{113} GAO. Xiang & BUCKLEY, RP ,2003 113.
\bibitem{114} Ibid
\bibitem{115} GAO X & BUCKLEY, RP (2003) 114
\end{thebibliography}
relations, format, presentation, originals and copies and examination of electronic records.”

Article 2 of eUCP emphasized on consistency of the all articles of eUCP with UCP while their application is only in case of electronic presentation. While using the eUCP, credit will be also subjected to UCP without any express incorporation of it. Alongside with UCP, the same silent position towards fraud has been taken in e-UCP.

4.4. Uniform Rules of Contract Guarantees (URCG)

URCG was introduced by ICC in early 1970s in order to address the need for set of rules which deal with existing inconsistencies in field of “[g]uarantees given by banks, insurance or services or the performance of work.” Therefore, unlike UCP which was regulating the process of Letter of Credit URCG was an attempt to deal with unfair calls for demand guarantees which can be considered as a measure to address problem of fraud. Despite all expectations, URCG was not welcomed by the international business society for few reasons including: the problem that applicability of URCG was only limited to independent guarantees and it had no effect on accessory guarantees.

The other problem was the result of URCG’s attempt to prevent unfair call on demand guarantees by requiring beneficiary to produce an evidence of failure in the format of judgement, arbitral award or the principal’s written approval at the time of making the claim.

It is submitted that fraud in documentary letters of credit has not been fully addressed under article 9 of URCG. Gao believes that while article 9 of URCG enumerates condition under which payment under independent guarantees will be

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116 Ibid
117 Ibid
119 URCG , Article 9 :
If a guarantee does not specify the documentation to be produced in support of a claim or merely specifies only a statement of claim by the beneficiary, the beneficiary must submit:
(a.) in the case of a tender guarantee, his declaration that the principal’s tender has been accepted and that the principal has then either failed to sign the contract or has failed to submit a performance guarantee as provided for in the tender, and his declaration of agreement, addressed to the principal, to have any dispute on any claim by the principal for payment to him by the beneficiary of all or part of the amount paid under the guarantee settled by a judicial or arbitral tribunal as specified in the tender documents or, if not so specified or otherwise agreed upon, by arbitration in accordance with the Rules of the ICC Court of Arbitration or with the UNCITRAL Arbitration Rules, at the option of the principal;
(b.) in the case of a performance guarantee or of a repayment guarantee, either a court decision or an arbitral award justifying the claim, or approval
120 Gao X & Buckley RP (2003) .114
121 URCG , Article 8(3) and 9
122 GAO, Xiang, The Fraud Rule under the UN Convention on Independent Guarantees and Standby Letters of Credit: A Significant Contribution from an International Perspective. George Mason Journal of International Commercial Law, 2010,Fall. 64
due, fraud rule covers situation that permits instruction of payment under bank
guarantee or letter of credit\textsuperscript{123}. As a result, it is possible to conclude that drafters
of URCG tried to tap on the problem of fraud but the final outcome lacks any sort
of precision.

4.5. Uniform Rules for the Demand Guarantees (URDG)

The failure of URCG in attracting the attention of the business society at global
level was the reason for ICC to introduce new set of rules and take a different
approach to Demand Guarantees. URDG 458 came into force by 1992 and based
on a model which was applied by British Bankers\textsuperscript{124}. Despite the fact that URDG
458 was strongly influenced by UCP, but still \textit{“[w]orldwide acceptance of the Rules ha[s] been disappointing”}\textsuperscript{125}. URDG 758 which is the revised version of URDG 458 came into force on 1 July 2010. It tries to address problems of previous version and set out functions and obligations of parties to the demand-guarantee by reflecting
the best practices in business of guarantees.\textsuperscript{126}

Similar to URCG, it is not possible to find a direct approach to fraud in URDG.
However, article 20 of the URDG takes an implicit approach to fraud.\textsuperscript{127} Clear
similarity between article 20 of URDG and article 9 of URCG shows intention of
drafters towards providing a safety mechanism for payment under guarantee rather
than direct reference to a measure which can prevent fraud.

4.6. International Standard Practice (ISP 98)

“ISP.98 is a set of rules specifically designed for standby letters of credit”\textsuperscript{128}. It
was originally introduced by American institute of International Banking Law

\textsuperscript{123} Ibid
\textsuperscript{124} INT’L CHAMBER OF COMMERCE, ICC PUBLICATION No. 458
\textsuperscript{125} Katz.R, Report delivered at the I.C.C. Hong Kong meeting, reprinted in INT’L CHAMBER OF COMMERCE,
ICC PUBLICATION No. 470/893, 19
\textsuperscript{126} BARANAELLO, J ‘Understanding the URDG 758’(2010) (http://www.fpsc.com/DB/TreasuryPulse/
\textsuperscript{127} URDG Article 20 :
\textsuperscript{128} GAO. Xiang & BUCKLEY RP (2003), 115
and Practice. ISP 98 received approval by ICC in 1998 and came into effect by January 1999. Historically, Standby Letters of Credits have been in use for many decades without being subjected to specific regulations. They were mostly regulated by UCP; however, application of UCP to Standby Letters of Credits was source of many problems as UCP was “originally written for use only in commercial letters of credit... many of the provisions of the U.C.P. are either inapplicable or inappropriate in a standby credit context.” On the other hand, it was possible for Standby Letters of Credit to be governed by URDG due to similarity between legal character of Demand Guarantees and Standby Letters of Credits. However, URDG is becoming more popular after coming into force of its new revision URDG 758 and “[f]rom the viewpoint of the I.C.C ..... Standby letters of credit continue to be covered by the U.C.P. and are not covered by the U.R.D.G.” Initially, similar to UCP for regulating the function of Commercial Letters of Credits URDG for Independent Guarantees, and ISP 98 was drafted for the purpose of regulating Standby Letters of Credits. However, “Like the UCP and the URDG, ISP98 [applies] to any independent undertaking issued subject to it”.

While article 20 of URDG tries to define a safety mechanism and reason for effectuating payment under the demand guarantee, Rules 4.16 ad 4.17 of ISP 98 provide that effectuating payment under the stand by letter of credit does not need any default or conditions relevant to underlying contract where such situation is not required by the credit. Therefore, it is possible to conclude that ISP 98 does not even address problem of fraud in an implied manner.

4.7. United Nation’s Convention on Independent Guarantees and Standby Letters of Credits

UNCITRAL Convention has been drafted by an intergovernmental organization which is body of United Nations General Assembly and works on preparation of instruments for harmonization of law regarding international trade. Convention has been adopted by UN General Assembly on 11 December of 1995. Standby letters of credits and independent guarantees or any other international undertaking can be subjected to the UCITRAL Convention.
“the place of business of the guarantor/issuer at which the undertaking is issued is in a Contracting State,” or “the rules of private law lead to the application of the law of a Contracting State,” “unless the undertaking excludes the application of the Convention.”

In case of Commercial Letters of Credit, by express address of parties to the credit UNCITRAL Convention can be used as the governing law.\textsuperscript{136} Although, UCP and URDG have been used as bases for drafting the UNCITRAL Convention, it is possible to distinguish some differences among them. First, UCP and URDG have been drafted by ICC which is a private institute and its approvals might only have application as voluntary rules or self-regulations while UNCITRAL Convention is a uniform law and official regulation applied to signatory countries which has been drafted by an international organization.\textsuperscript{137} Therefore, UNCITRAL Convention can be differentiated from ICC rules due to its legal statues. In addition, UNCITRAL Convention, consist of complementary provisions to UCP 600, URDG and ISP 98 including abusive demand, fraud and remedies which are discussed under the section 19 of Convection.

4.7.1. UNCITRAL Convention’s View

In late 1995 the United Nations Convention on Independent Guarantees and Standby Letters of Credit came into force with the goal of facilitating the function of Independent Guarantees and Standby Letters of Credit in international trade. The Convention is effective in contracting States and despite the fact that its scope is limited to demand guarantees and standby letters of credit, it has application to Commercial Documentary Letters of Credit as well. This convention is the first international effort to address the problem of fraud in international LC transaction and three of its articles (article 15,19 and 20) directly deal with abusive and fraudulent demand for payment under standby letters of credit and independent guarantees plus ways to prevent them. Therefore, Convention is considered a supportive regulatory framework to UCP. However; the word fraud has not been mentioned throughout the convention following the logic of preventing confusions which may result from different interpretations of the term in different jurisdictions.

Article 15 is the guideline for beneficiary in making the demand under standby letters of credit and independent guarantees. It refers to condition under which beneficiary’s demand can be prevented: “[t]he beneficiary, when demanding payment, is deemed to certify that the demand is not in bad faith (for example by providing confirmation letters from an authorized inspection firm regarding compliance of shipped consignment with terms of LC) and that none of the elements referred to in subparagraphs (a), (b) and (c) of paragraph 1 of article 19 are present.”

\textsuperscript{136} UNCITRAL CONVENTION art. l(1)(b).
\textsuperscript{137} UNCITRAL CONVENTION art. l(2)
Article 19 titled: “Exceptions to payment obligation” provides list of situations which provides issues with choice of refusing demanded payment by beneficiary. Paragraph (1) provides that: “Any document is not genuine or has been falsified; no payment is due on the basis asserted in the demand and the supporting documents; or Judging by the type and purpose of the undertaking, the demand has no conceivable basis...”. Paragraph 2 explains the meaning of “no conceivable basis” :“ (a)The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialised; (b)The underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking;(c) The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary; (d) Fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary;(e) or In the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor/issuer of the undertaking to which the counter-guarantee relates”.

Further, paragraph (3) of the same article provides that: “in the circumstances set out in subparagraphs (a), (b) and (c) of paragraph 1 of this article, the principal/applicant is entitled to provisional court measures in accordance with article 20”. Scholars consider article 19 of convention successful in achieving it political and technical objectives.

Article 20 continues with providing possibilities for court action under the title of “Provisional court measures”:

1. Where, on an application by the principal/applicant or the instructing party, it is shown that there is a high probability that, with regard to a demand made, or expected to be made, by the beneficiary, one of the circumstances referred to in subparagraphs (a), (b) and (c) of paragraph 1 of article 19 is present, the court, on the basis of immediately available strong evidence, may: a. Issue a provisional order to the effect that the beneficiary does not receive payment, including an order that the guarantor/issuer hold the amount of the undertaking, or b. Issue a provisional court order to the effect that the proceeds of the undertaking paid to the beneficiary are blocked, taking into account whether in the absence of such an order the principal/applicant would be likely to suffer serious harm.

2. The court, when issuing a provisional order referred to in paragraph 1 of this article, may require the person applying therefor to furnish such form of security as the court deems appropriate.

3. The court may not issue a provisional order of the kind referred to in paragraph 1 of this article based on any objection to payment other than those referred to in subparagraphs (a), (b) and (c) of paragraph 1 of article 19, or use of the undertaking for a criminal purpose”
From technical point of view, the Convention is successful in addressing major aspects of fraud rule developed by national courts in addition to offering a precise and useful guideline. Article 19 (1) lists types of misconduct by beneficiary which result in application of fraud rule both under LC contract and underlying sales contract. Also Convention provides guidance for actions which victim of fraud can take by either withholding payment or refusing to honour presentation (bank) and applying for injunction remedy at court (applicant) in order to prevent issuing bank from honouring fraudulent presentation. Gao and Buckley consider fraud related provisions in UNCITRAL Convention as vital and positive development which can be used as a guide for national courts while applying the fraud rule.

There are two main criticisms to UNCITRAL Convention articles on fraud. On one hand, scholars criticize vagueness of provisions which might create problem in practice of independent undertakings. On the other hand, other scholars express concern on possibility for different court interpretations as result of applying Convention’s provisions which might increase the risk of international trade. In conclusion, UNCITRAL Convention has provided a constructive development in international application of LC fraud rule despite existence of different interpretations among national courts which will be discussed in later chapters of this paper.

5. Conclusion

Documentary letters of credit are among most popular instruments used by traders and banks in the field of international trade finance. Despite their facilitating nature in smoothing up the process of international transactions, their mere documentary nature makes them vulnerable to the problem of fraud. Situation will become more complicated as the United States of America is the only country which has statutory regulations to regulate fraud in LC operation. England is following fragmented approach based on case law and other countries do not really have significant regulations in above mentioned area. Current paper tried to analyse the problem of fraud as a globally accepted exception to the principle of autonomy in documentary letters of credit by scrutinizing national legal systems in England and the USA as well as international legal framework applicable to LC operation which have been introduced by ICC and UNCIRAL.

Despite the fact that UCC and English law cover the fraud exception to an extensive level, ICC regulations show no trace of paying attention to such important problem. Among internationally accepted norms, Only UNCITRAL Convention provides provisions on how to face with fraud in LC operation. This is clearly not sufficient as majority of LC users and active traders in international business have no detailed knowledge from American and English legal system. On the other hand, UNCETRAL Convention is only ratified by nominal number of countries which limits its application extensively. It is recommended to include fraud exception in ICC rules particularly UCP due to its extensive use as applicable law in process of
LC Operation. On one hand inclusion of fraud rule in UCP will increase the clarity and expectably of LC operation and on the other hand it will reduce current existing problems of judges who are not familiar with detailed operation of documentary credits and bankers who have no legal expertise on how to deal with legal aspects of LC fraud in national legal systems.

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6.5. 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 documentary 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 century138. 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 con-tract 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

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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.

2. The Principle of Strict Compliance

The principle of Strict Compliance express that issuing a bank’s undertaking to
honor the credit is effective only upon presentation of complying documents by the
beneficiary which are stipulated in the credit\textsuperscript{139}. 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”\textsuperscript{140}. Therefore, banks who act as an agent for applicant in
documentary credits will receive reimbursement in case of honoring 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

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.

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”\textsuperscript{146}.

The majority of discrepancies in practice of Documentary Letters of Credit include
inconsistent data\textsuperscript{141}, discrepant documents of transport\textsuperscript{142}, mistakes in draft\textsuperscript{143}, drafts
without signature and inconsistent invoice with credit\textsuperscript{144}, inadequate insurance\textsuperscript{145},
and documents with wrong signature\textsuperscript{146}.

\textsuperscript{139} Inter alia Article 2; Article 7(a), Article 8(a)(c) and Article 15; Article 14 and Article 34 of UCP 600.
\textsuperscript{140} R. King, Gutteridge and Megrah’s law of bankers’ commercial credits, London 2001, p. 14
\textsuperscript{141} Article 14(d) UCP 600
\textsuperscript{142} Article 19 UCP 600
\textsuperscript{143} Article 18(c) UCP 600
\textsuperscript{144} Article 28 UCP 600
\textsuperscript{145} B. Baker, Exporting Against Letters of Credit, http://www.financepractitioner.com/operations-management-
best-practice/exporting-against-letters-of-credit/ (last visited 08.03.2017).
\textsuperscript{146} Article 34 UCP 600.
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 about what constitutes the complying presentation which can be traced into legal cases\textsuperscript{147}. However, the most important question can be what is the characteristic of non-complying presentation?\textsuperscript{148}

There are two main theories regarding the determination of documentary compliance: Doctrine of Strict Compliance and Doctrine of Substantial Compliance\textsuperscript{149}.

2.1. Doctrine of Strict Compliance

According to the doctrine of Strict Compliance, presented documents should strictly comply with credit\textsuperscript{150}. 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 600\textsuperscript{151}. 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 errors\textsuperscript{152}. 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\textsuperscript{153}, 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 presentation\textsuperscript{154}:

\begin{quote}
\textquote{\[The plaintiffs\] 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 can- not regard as trivial something which, whatever may be the reason, the credit
\end{quote}

\textsuperscript{147} H. M. S. Botosh, Striking the Balance between the Consideration of Certainty and Fairness in the Law Governing Letters of Credit, http://theses.whiterose.ac.uk/3063/ (last visited 09.03.2017), pp. 183-271.
\textsuperscript{149} Ibid
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\textsuperscript{154} Ibid
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 bank\textsuperscript{155}.

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 credit\textsuperscript{156}. Other articles provide tolerance of 5 percent when quantity is not defined in the credit\textsuperscript{157}.

2.1.2. Material Discrepancy

There are numerous cases on material discrepancies. In \textit{JH Raynor & Co. Ltd v. Hambro’s Bank Ltd}\textsuperscript{158}, the shipped goods were described in the bill of lading as “ma-chine-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 trade\textsuperscript{159}.

Other example is \textit{Courtaulds North America, Inc. v. North Carolina Nat. Bank}\textsuperscript{160} 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 presentation\textsuperscript{161}. The court held that the bank was entitled to dishonor the presentation de-spite 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 documents\textsuperscript{162}.

“Free of ineptness in wording the letter of credit dictated that each invoice express

\textsuperscript{156} UCP600, Article 30 (a)
\textsuperscript{157} UCP 600, Article 30 (b)
\textsuperscript{159} Ibid
\textsuperscript{161} Ibid. p.806
\textsuperscript{162} Ibid
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.\textsuperscript{163}

\textit{Bank Melli Iran v. Barclays Bank (Dominion, Colonial & Overseas)}\textsuperscript{164} 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 same.\textsuperscript{165}

\section*{2.2. Substantial Compliance}

It is the test accepted by few courts in order to balance the interests.\textsuperscript{166} 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”.\textsuperscript{167} 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 services.\textsuperscript{168}

\section*{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 frameworks.\textsuperscript{169} The principle of autonomy of letters of credit has been considered as “cornerstone of the commercial validity of the letters of credit”\textsuperscript{170}, and “the engine behind the letter of credit”\textsuperscript{171}. 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

\textsuperscript{163} Ibid
\textsuperscript{164} Bank Melli Iran v Barclays Bank (Dominion, Colonial & Overseas) Lloyd's Law Reports 1951, Vol. 2. No. 367
\textsuperscript{165} Ibid
\textsuperscript{167} Ibid.
\textsuperscript{168} UCP 600, Article 5
\textsuperscript{169} 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
\textsuperscript{170} Ward Petroleum Corp. v Federal Deposit Ins. Corp. (1990) 903 F.2d 1299
\textsuperscript{171} J. Dolan, The Law of Letters of Credits, Boston 2002 [12.03]480

163
by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honor, to negotiate or to fulfill any other obligation under the credit is not subject to claims or defenses 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”.172

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”173.

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”174.

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174 UCP 600 , Article 5
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 trade\textsuperscript{175}. 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 contract\textsuperscript{176}.

3.1.2. Commercial Function

The commercial function of the Principle of Autonomy has been discussed by Professor McCormarck as an assurance for reimbursement of the issuer based only on the complying tender document by the beneficiary while requiring it to undertake the ministerial function of document checking\textsuperscript{177} and fund transfer\textsuperscript{178} in order to remove any doubts about its payment undertaking\textsuperscript{179}. On this basis, the British cases bind the bank to pay even on the occasion of tendering forged\textsuperscript{180} and incorrect documents\textsuperscript{181} and regardless of the facts represented by the documents\textsuperscript{182}.

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 beneficiary\textsuperscript{183}. Secondly, it provides a support of leveraging other transactions for the beneficiary by the credit which has been issued in his favor\textsuperscript{184}.

Finally, comments of Hirst J in \textit{Tuckan Timber Ltd v. Barclays Bank Plc}\textsuperscript{185} clearly illustrates bank’s obligations under documentary credits.

\textsuperscript{175} G. McCormack, Subrogation and Bankers Autonomous Undertakings, Law Quarterly Review 2000, No. 45
\textsuperscript{176} R. P. Buckley, X. Gao, The Development of the Fraud Rule in Letter of Credit Law: The Journey so Far
\textsuperscript{178} G. McCormack, Subrogation…
\textsuperscript{179} C. Hare, Not so Black and White…
\textsuperscript{181} Pacific Composites Ply Ltd & Anor v. Transpac Container System Ltd & Ors
\textsuperscript{183} 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
“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 honoring a letter of credit in accordance with its terms bearing in mind the importance of the free and unrestricted flow of normal commercial dealings.”

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 honor 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 sales. 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: 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.

186 Ibid.36
of fraud in LC transaction\textsuperscript{189} \textit{Sztejn  v Henry Schroder Banking Corporation}\textsuperscript{190} 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.

\textbf{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\textsuperscript{191}.

\textbf{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 period\textsuperscript{192}. The exchange rate risk will be against the applicant when her local currency is depreciating against the currency of the credit.

\textbf{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.

\textsuperscript{190} Sztejn v Henry Schroder Banking Corporation 31 NYS 2d 631 (1941).
\textsuperscript{191} K. Godier, Trends Show a Declining Reliance on Letters of Credit, Documentary Credits Insight 2001, Vol. 7, No. 3.
\textsuperscript{192} Y. Hao, L. Xiao, Risk Analysis of Letter of Credit, International Journal of Business and Social Sciences 2013, Vol. 4, No. 9, p. 207
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 restitute 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 documents193.

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 favor. 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’194.

4.2.2. Imposing intentional restrictions

The intentionally imposed restrictions by the applicant in the Letter of 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.

194 Y. Hao, L. Xiao, Risk Analysis...
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 regimes\textsuperscript{195}. 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 Company\textsuperscript{196}. 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 amendment\textsuperscript{197}. 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.

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.\textsuperscript{198} 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.

\textsuperscript{195} Ibid.
\textsuperscript{196} Ibid.
\textsuperscript{197} Ibid.40
\textsuperscript{198} Ibid
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.

b) 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 ICC\textsuperscript{199} the global rate of documentary discrepancy in LC transaction is about 60–70%.

Documentary discrepancy rate in the USA is considered about 73\%\textsuperscript{200} while in the UK it has been estimated to have amounted up to 50–60\%\textsuperscript{201}. 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”\textsuperscript{202}.

As it was mentioned before, the majority of discrepancies in practice of Documentary Letters of Credit include inconsistent data\textsuperscript{203}, discrepant documents of transport\textsuperscript{204}, mistakes in drafts\textsuperscript{205}, drafts without signature and inconsistent invoice with the credit\textsuperscript{206}, inadequate insurance\textsuperscript{207}, and documents with wrong


\textsuperscript{203} Article 14(d) UCP 600

\textsuperscript{204} Article 14(d) UCP 600

\textsuperscript{205} Article 19 UCP 600

\textsuperscript{206} Article 18(c) UCP 600

\textsuperscript{207} Article 28 UCP 600
signature. 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 operations. 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 Macro and Transactional Risks.

Macro Risks

The Marco 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 in situations, 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 counterparties in other countries in order to secure receiving payment by them.

4.3.1. 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 operation. 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

210 Ibid. 42
211 Ibid 20
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.

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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6.6. DOCUMENTARY LETTERS OF CREDIT, LEGAL NATURE AND SOURCES OF LAW

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Abstract
There is no doubt about risky nature of international trade. Such risk can be conceptualized as country risk, transportation risk, customer risk and etc. Documentary Letters of Credit (LC) are used as a method of payment in international business for many centuries in order to reduce risk of trade specially when parties are located in different countries and do not have precise information from financial standing of each other. In such occasion LC will reduce the risk of trade by shifting payment obligation from buyer as an individual to a payment guarantee of a bank as a legal entity in return for presentation of complying documents with terms of credit by seller. Familiarity with legal nature and different legal frameworks which govern the international operation of documentary letters of credit can facilitate the process of international trade for businessmen and boost national economies. However, lack of knowledge about them can impose huge losses on international traders. Situation will be more complicated when we understand that there are many internationally recognized legal frameworks which can affect the operation of LC and they get frequently updated in order to address technological and economic developments in global market. In this paper, author tries to answer questions regarding (i) what are international legal frameworks governing operation of documentary letters of credit? (ii) which areas of LC operation has been covered by them and (iii) how do they address the legal questions regarding international operation of documentary letters of credit?

Key Words: Documentary Letters of Credit, Legal Framework, International Trade, Payment Risk.

1. Introduction

Documentary Credits, Documentary Letters of Credit or Banker’s Documentary Letters of Credits are one of the old and well appreciated existing instruments for financing the international trade. Such long history of Documentary Letters of Credits has resulted in letting them to be considered as “Life Blood of Commerce”212. In terminology, Letter of Credits has roots in the French word ‘Accredetif’ with the meaning of power for doing something. However, Accredetif itself comes from

‘Accreditiwus’ in Latin which conveys the meaning of ‘Trust’.  

There is no doubt about historical uses of Letters of Credit in International Trade. Their usage in practice of international trade has been traced to banking systems of old Egypt and Babylon. Some excavations in Babylon provide evidences of promissory notes from 3000 B.C that show the promise for payment of exact amount and relevant interest rate in a defined date. Also evidences from ancient Greece show drawing of Letter of Credits by banks to their correspondents in order to obviate the transport of Spices in return to payment of accounts. During middle Ages, Letters of Credits were used in order to solve two distinctive trade problems. (A) Lack of security in carriage of precious items and gold by merchants during their business trips and (B) Lack of common trade currency for meeting the cash need of merchant’s abroad. Due to security risks of carrying cash in hand, merchants of those days were preferring to exchange their cash with a ‘letter of credit’ at their bank with the capability of being cashed in another bank at given destination.

According to the De Rover, Letters of Credit were in use by Medici Bank during late 1300s in Bruges and Italy. In the course of time, London gained fame as an outstanding financial centre due to growth of international trade and raise of British Banking System as monopolistic issuer of Letter of Credit which was a result of accepting Pound Sterling as currency for international trade created.

Letter of Credits entered United States of America after raising competition among factoring houses and acceptance of drafts against shipment. In today’s world, Letters of Credits are considered among the most attractive areas of research for legal, international trade and finance scholars. In this respect, Professor Roy Goode defines Documentary Letters of Credits as: ‘A money promise which is independent of the transaction that gives it birth and which is considered binding when received by the beneficiary without acceptance, consideration, reliance, or execution of solemn form’. Latest version of Uniformed Customs and Practice for Documentary Credits (UCP 600) defines Letters of Credit as: ‘An arrangement however named or described, that is irrevocable and thereby constitutes and definite


217 De Roover. R, Money, Banking and Credit in Medieval Bruges, 2 Journal of Economic History (Suppl. Issue), 1942, p.52


219 Goode.R, ‘Abstract Payment Undertakings’ in Peter Cane and Jane Stapleton (eds), Essays for Patrick Atiyah (OUP 1991)
undertaking of the issuing bank to honour the complying presentation”4. Further, Article 2 of UCP 600 considers complying presentation as “a presentation that is in accordance with terms and conditions of the credit, the applicable provisions of this rule and international standard banking practice”220. Among other definitions, Kudriachov describes Letters of Credits as “one way abstract transaction, in which the emitting bank cannot reject the execution of its obligation by referring to non-execution of obligations by other parties to the transaction”221.

Although, Documentary Credits have very long mercantile history, their involvement to utilization of credit arrangements practically goes back to the second half of the 19th century222. Therefore, current article tries to a review on general aspects of Letter of Credit operation, international legal frameworks applicable to LC transactions and main legal principles in operation of Letters of Credits. A review of legal history of Documentary Letters of Credits shows that Rose v Von Mierop and Hopkins223 is one of the first lawsuits on letters of credits and landmark of LCs Law in English legal system224.

1.1. Functions and process of the operation in Documentary Credits

Article 2 of UCP (600) defines parties to the Letter of Credit as following: “Applicant: the party to whose request the credit is issued. Beneficiary: The party in whose favour the credit is issued. Issuing Bank: Means the bank that issues a credit at the request of an applicant or on its own behalf”225. Basically, the process of issuing a Letter of Credit starts with request of Buyer (applicant or Account Party) to his bank (issuing bank) in order to issue a credit in favour of the seller (Beneficiary) based on the underlying contract of sales between parties. As a result, issuing bank will contact beneficiary in his country in order to inform him about opening the credit in his favour. Due to a geographical distance between issuing bank and beneficiary, advise of the credit to beneficiary will generally take place via a correspondent of issuing bank in beneficiaries country (advising bank). The responsibility of advising bank is only informing beneficiary about issuing credit in his favour and it does not have any obligation of payment towards beneficiary226. As a result, the legal nature of relationship between issuing bank and advising bank is considered as relationship between agent and principle227.

220 Article 2, UCP 600
221 Koudriachov. SA. (2001), 5
222 Garcia RLF (2009) . 69
225 Article 2 UCP 600
226 Article 9.a, UCP 600
227 Gian Singh and Co Ltd v Banque de l’Indochine [1974] 1 WLR 1324, 1238
Beneficiary seller at this stage must compare terms and conditions of the credit with terms of underlying contract. In case of any existing discrepancy at this stage, beneficiary is entitled either to reject the credit or require amendments. After approval of the credit by beneficiary, issuing bank will enter into a contract with Beneficiary to provide him with price of merchandise in return of complying documents required by the credit. As a result, any given credit will have at least three parties. Namely, Issuing bank, Beneficiary and Applicant. However, in practice number of parties might be more than three. It might happen that issuing bank asks advising or any other bank in the country of seller to provide credit on her counter which is a very appreciated option for beneficiary who will be paid in his own country rather than the country of the buyer. In this case, the bank which provides credit on her counter is considered as Nominated Bank\textsuperscript{228}. In some occasions, seller might ask for higher guarantee for payment which is already provided by issuing bank. In this case a confirming bank will add her irrevocable commitment for payment of the credit to beneficiary in addition to issuing bank. As a result, any given Documentary Letter of Credit will consist of at least three independent contracts between Beneficiary and Applicant (Underlying Contract of Sales), Account Party and Issuing Bank, Issuing Bank and Beneficiary. However, in majority of cases number of contracts will increase relatively with the increasing number of involved parties in the credit after joining confirming bank and Nominated Bank to original parties to the Documentary Credits.

Enonchong\textsuperscript{229} introduces four generic functions for the Letter for Credits. First, Letter of credit reduces commercial risk both for importer and exporter by providing security of payment for exporter and security against the non-delivery of goods for importer. Second function is providing finance for importer and helping him with cash flow while at the same time providing exporter with the chance to raise money before being paid by issuing bank. Third, Documentary Credits can be used as security for other obligations like case of Back-to-Back letter of credits. Fourth, is the function of documentary credits as conditional payment method and providing the possibility for seller to receive payment from importer in case the credit has been dishonoured by bank.

Function of Documentary Letters of Credit follows different steps of the Letter of Credit’s process\textsuperscript{230}. Process starts with negotiation of the terms of contract by buyer and seller. They will enter the underlying contract of sales. According the underlying contract, exporter will undertake to provide confirmed goods which are subjected to that particular transaction and importer commits to pay the price of good via Documentary Letter of Credits. Further, information regarding the details of the Credit will be also mentioned in the underlying contract. As the second phase, the buyer will require the issuing bank to open a credit in favour of exporter.

\textsuperscript{228} UCP 600 – Article 2
\textsuperscript{230} Ibid. 8
In case of issuing bank’s agreement to issue the credit, Importer (account party) to pay him the price of goods sold to the importer in return of delivering confirming stipulated documents in the credit\textsuperscript{231}. Although, these three independent contracts are considered as basic framework for function of Documentary Letter of Credits, but in practice, in majority of occasions, beneficiary will interact with a local bank in his own country rather than being involved directly with issuing bank. If parties decide so, then the advising bank will contact the beneficiary in order to inform him about the issuing of the credit in his favour. At the time that credit requires involvement of Nominated Bank and Confirming Bank, there will be a separate contract between Beneficiary and Nominated or Confirming Bank and Issuing Bank and Nominated and Confirming Bank. Advising Bank might or might not accept to act in the capacity of Nominated and /or Confirming Bank.

As a result, beneficiary ships goods for account party and provides confirming stipulated documents in the credit to the issuing bank, Nominated Bank or Confirming Bank. Nominated Bank will check presented documents and in case of conformity, they will pay beneficiary based on the authorisation in issuing bank\textsuperscript{232}, transfer documents to issuing bank and wait for reimbursement\textsuperscript{233}. Issuing bank also check documents and in case of their conformity will reimburse Nominated or Confirming Bank, debit the account of applicant and inform him to come and receive his documents.

As it was mentioned earlier, most of the time credit will require the involvement of Nominated Bank and Confirming Bank as Issuing bank is not located in country of Beneficiary and it is difficult for him the confirm the authenticity of signatures by issuing bank\textsuperscript{234}.

2. Legal Nature and Sources of the Letter of Credit Law

2.1. Background

The exact time that Letters of Credits started to function as their modern form is not clear\textsuperscript{235}. However, most researchers tend to agree that emergence of the modern letters of credits started from the middle of nineteenth century\textsuperscript{236}. Reviewing the history of Documentary Letters of Credit, explains formation of modern forms of credit as response to demands in commercial world by developing primitive forms

\textsuperscript{231} Article 7- UCP 600.
\textsuperscript{232} Längerich R ‘Documentary Credits in Practice’ (2000) 106
\textsuperscript{233} Article 7( C), UCP 600
\textsuperscript{234} Längerich R (2000) 104
of credit. However, comparison between Modern Documentary Credits and Open Credits as one of the ancients types of credit provided by banks to merchant in international trade shows the ‘resemblance is only superficial’:

“1) The object of today’s letter of credit is to guarantee the payment of the purchase price in international sales of goods; the open letter of credit, on the other hand, was used to raise funds for merchants traveling overseas. A merchant who did not wish to carry cash but wished to obtain credit or cash in countries where it would have find it difficult to do so otherwise could ask his banker to issue an open letter of credit for him. On the faith of the open letter of credit, the merchant was able to obtain advances from foreign bankers against its drafts.

2) While the issuer of a modern letter of credit promises to pay a seller who has already entered into a contract for the sale of the goods provided the seller submits the required documents, the issuer of an open letter of credit asked others to advance money to his customer.

3) In a modern letter of credit the credit is given to some third party with whom the customer has some commercial dealings; in the open letter of credit the letter was given to the banker’s customer.”

Reviewing the history of modern Letter of Credit also shows deference between their legal nature with other instruments used in international trade including negotiable instruments and Contracts of Sales.

2.2. Sources of Letter of Credit Law

In the course of history, development of law and regulations of the Documentary Letter of Credit was based on custom. However, in modern time; International Chamber of commerce has provided the major source of law for documentary letters of by assuming the responsibility for codification of relevant customs and usage under Unified Custom and Practices for Documentary Credits (UCP). Additional to UCP, International Chamber of Commerce has introduced other regulations including eUCP, Uniform Rules of Contract Guarantees, Uniform Rules for Demand Guarantees, ISP98, which is International Standby Practices for Independent Guarantees and Standby Documentary Credits. United Nations Conference for International Trade Law also individually took the initiative to prepare universal regulations for Independent Guarantees and Standby Letters of Credits which is known as UNCITRAL Convention. Despite existence of many

237 Gao Xiang (2003). 105
238 Kozolchyk, B. 1966,4
international frame works for regulation of documentary credits, this issue has been addressed in few national law systems. Among Civil Law countries only Colombia, El Salvador, Greece, Guatemala, Honduras, Lebanon, Mexico, and Syria have statutory rules on the letter of credit; and, the only country in the common law system is the United States. In other Common Law Countries including England, Legal issues of documentary credits are subjected to case law.

The main focus of current paper in this section will be study of different International legal sources for documentary credits, and also the answer of common law system to the question of legal framework for documentary credits._

2.2.1. Uniform Customs and Practice for Documentary Credits (UCP)

UCP is the product of harmonization process for international law in order to facilitate the process of international trade and reducing conflicts among different legal systems. By escalating amount of international trade at the beginning of 20th century as the expected aftermath of industrial revolution first national attempts towards harmonization of Letter of Credit Law stated in 1920’s. The process of harmonization of LC law at national level started in the United States of America by drafting relevant banking regulations for Letter of Credit Operation by New American Commercial Credit Conference240 which was followed by European countries241. At international level, Amsterdam Conference of International Chamber of Commerce in 1929 was the first step where proposed law was adopted only by France and Belgium242. A revised version of the text was introduced in 1933 by the Commission on Banking Technique and Practice of the International Chamber of Commerce at Vienna Conference and received acceptance from some European countries and individual American banks243. Further revisions on the code by ICC started after the end of World War II. During Lisbon Conference of ICC in 1951 new revision of harmonized code for international operation of LC was introduced which was adopted by several African and Asian banks but got rejection by England. New revision of UCP took place in 1962 following the objective of receiving worldwide application244 and received adoption by banks in Britain and Commonwealth countries. In 1974 the new revision of UCP was introduced in order to meet the global needs for container shipping and multimodal transport which received breakthrough achievement of being adopted by 162 countries245. Next revision in UCP happened in 1983 which is known as UCP


241 Ibid


245 ICC publication no 290
Innovations introduced in UCP 400 were trying to cope with challenges facing international trade due to fast developing technology and communication methods by addressing: 1) introducing negotiation of document under letter of credit 2) application of UCP to Deferred Payment LCs and Standby LCs and 3) Using SWIFT for transmission of documents and LC. Further revision of UCP was adopted in ICC conference in Mexico in 1993 and came into force by first January 1994. It is known as UCP 500 which was an improvement to UCP 400. It introduced the notion of nominated bank, bank duty to examine documents and their rejection. New provisions regarding documents (articles 23-30 on transport documents, article 34-36 on insurance documents, and article 37 on commercial invoice). Finally, the current revision of UCP known as UCP 600 came into force in 2007 and brought about further developments in international LC operation. UCP 600 can be named as the most trade friendly among all versions of Unified Customs and Practices for Documentary Letters of Credit. Also by many scholars considered UCP 600 as a forward movement in harmonisation of LC regulations in international trade. Main developments in UCP 600 in comparison with former versions can be categorized as: Introducing UCP articles as Rule for the first time. Reducing number of articles from 49 in UCP 500 to 39 in UCP 600, providing more clarification by defining honour, negotiation and presentation, not recognition of revocable Documentary Letters of Credit, defining new standard of examination of documents by bank, clarification of the role of banks in deferred payment system, identification of careers and agent, providing clarity about documents relevant to multimodal transport and finally, providing clear definition for original document.

UCP has no legislative authority, as it is neither a convention nor ICC is a

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246 ICC Publication no 434.
248 ICC publication no 500.
249 UCP 500. Article 10(b).
250 UCP 500 Article 13(a).
251 UCP 500 Article 14.
252 Rodrigo, T., 2011. UCP 500 to 600: A forward movement. eLaw J., 18, p.20
253 Ibid
254 UCP 600, Article 1.
255 UCP 600, Article 2
256 Ibid
257 UCP 600, Article 14
258 UCP 600, Article 7
259 UCP 600, Article 14
260 UCP 600, Article 19
261 UCP 600, Article 17.
governmental organization\textsuperscript{263}. Therefore, despite the fact that its introduction in Article 1 of UCP 600 as “rules”, we can consider it as globally recognized banking customs and practices which are only applicable to Documentary Letters of Credits through incorporation\textsuperscript{264}. UCP was developed due to the need for recognition of uniform procedures which could harmonize the practice of Documentary Credit at global level\textsuperscript{265}.

\textbf{eUCP}

“This is the acronym for the supplement to the uniform Customs and Practice for Documentary Credits for Electronic Presentation”\textsuperscript{266}. Meeting the needs for electronic trade was the initiative of Banking Commotion of ICC to propose the formation of committee to work on developing a bridge between UCP and processing the electronic equivalent of paper based credits the working group started to work on preparation of a supplement to the UCP which “would deal with the issues of Electronic Presentation”\textsuperscript{267}. The result of working group’s efforts is known as eUCP. It came into force from 1 April 2002 and in the format of version issues in order to facilitate the necessities for further revisions\textsuperscript{268}. Current version of eUCP is the version 1.1. Issues covered by eUCP are: “eUCP- UCP relations, format, presentation, originals and copies and examination of electronic records”\textsuperscript{269}. Article 2 of eUCP emphasized on consistency of the all articles of eUCP with UCP while their application is only in case of electronic presentation. While using the eUCP, credit will be also subjected to UCP without any express incorporation of it\textsuperscript{270}.

\textbf{2.2.2. Uniform Rules of Contract Guarantees (URCG)}

URCG was introduced by ICC in early 1970s in order to address the need for set of rules which deal with existing inconsistencies in field of “guarantees given by banks, insurance or services or the performance of work.”\textsuperscript{271} Therefore, unlike UCP which was regulating the process of Letter of Credit URCG was an attempt to deal with unfair calls for demand guarantees. Despite all expectations, URCG was not welcomed by the international business society for few reasons including: the problem that applicability of URCG was only limited to independent guarantees and it had no effect on accessory guarantees\textsuperscript{272}. The other problem was the result of URCG’s attempt to prevent unfair call on

\begin{footnotesize}
\textsuperscript{263} Forewords to UCP 600
\textsuperscript{264} ICC Brochure No 82
\textsuperscript{265} UCP 600 Introduction .11
\textsuperscript{266} Gao X & Buckley RP (2003) .113.
\textsuperscript{267} Ibid
\textsuperscript{268} Gao X & Buckley RP (2003) .114
\textsuperscript{269} Ibid
\textsuperscript{270} Ibid
\textsuperscript{272} Gao X & Buckley RP (2003) .114
\end{footnotesize}
demand guarantees by requiring beneficiary to produce an evidence of failure in the format of judgement, arbitral award or the principal’s written approval at the time of making the claim273.

2.2.3. Uniform Rules for the Demand Guarantees (URDG)

The failure of URCG in attracting the attention of the business society at global level was the reason for ICC to introduce new set of rules and take a different approach to Demand Guarantees. URDG 458 came into force by 1992 and based on a model which was applied by British Bankers274. Despite the fact that URDG 458 was strongly influenced by UCP, but still “[w]orldwide acceptance of the Rules ha[s] been disappointing”275. URDG 758 which is the revised version of URDG 458 came into force on 1 July 2010. It tries to address problems of previous version and set out functions and obligations of parties to the demand-guarantee by reflecting the best practices in business of guarantees.276

2.2.4. International Standard Practice (ISP 98)

“ISP.98 is a set of rules specifically designed for standby letters of credit”277. It was originally introduced by American institute of International Banking Law and Practice. ISP 98 received approval by ICC in 1998278 and came into effect by January 1999. Historically, Standby Letters of Credits have been in use for many decades without being subjected to specific regulations. They were mostly regulated by UCP, however, application of UCP to Standby Letters of Credits was source of many problems as UCP was “originally written for use only in commercial letters of credit... many of the provisions of the U.C.P. are either inapplicable or inappropriate in a standby credit context.”279. On the other hand, it was possible for Standby Letters of Credit to be governed by URDG due to similarity between legal character of Demand Guarantees and Standby Letters of Credits. However, URDG is becoming more popular after coming into force of its new revision URDG 758 and “[f]rom the viewpoint of the I.C.C ..... Standby letters of credit continue to be covered by the U.C.P. and are not covered by the U.R.D.G.”280 Initially, similar to UCP for regulating the function of Commercial Letters of Credits URDG for Independent Guarantees, and ISP 98 was drafted

273 URCG , Article 8(3) and 9
274 INT’L CHAMBER OF COMMERCE, ICC PUBLICATION No. 458
275 Katz,R, Report delivered at the I.C.C, Hong Kong meeting, reprinted in INT’L CHAMBER OF COMMERCE, ICC PUBLICATION No. 470/893, 19
277 Gao X & Buckley RP (2003) ,115
278 INT’L CHAMBER OF COMMERCE, ICC PUBLICATION No. 590 (1998)
for the purpose of regulating Standby Letters of Credits. However, “Like the UCP and the URDG, ISP98 [applies] to any independent undertaking issued subject to it”\textsuperscript{281}.

2.2.5. \textbf{International Standard Banking Practice for the Examination of the Documents under Documentary Credits Subject to UCP 600 (ISBP)}

ISBP has been described by ICC as a great help to banks, corporates, logistics specialists and insurance companies\textsuperscript{282}. The main idea behind introducing it is the explanation of how to apply UCP in practice. For example, 185 sections of ISBP comment on documents which are not covered by UCP\textsuperscript{283}, expressions which are not defined in UCP\textsuperscript{284}, management of misspelling and specific types of errors\textsuperscript{285}; time for application of original and copies\textsuperscript{286}; methods of signing documents\textsuperscript{287}; and how to prepare insurance documents\textsuperscript{288}.

2.2.6. \textbf{Uniform Rules for Bank to Bank Reimbursement under Documentary Credits}

ICC introduced the URR 525 in order to standardize the bank to bank reimbursement process. Article 13(b) which is new in UCP 600 aligns it with URR 525\textsuperscript{289}. The last renewal process of URR took place in 2008 by replacing URR 525 with URR 725. According to ICC, URR 725 should not be considered as the revision of URR 525 as it is more an update in order to be in more alignment with UCP 600\textsuperscript{290}. Since URR 725 has not been incorporated into UCP 600, its application is only limited to bank to bank reimbursement based on explicit agreement to the reimbursement agreement\textsuperscript{291}.

Article 13(b) of UCP 600 will cover bank reimbursement obligations in absence of such provisions in reimbursement agreement.

\textsuperscript{281} James E. Byrne, Preface to JAMES E. BYRNE ET AL., INTERNATIONAL STANDBYPRACTICES ISP98 6. (ICC Publishing, Inc. 1998)
\textsuperscript{282} Introduction of ISBP
\textsuperscript{283} sections 19-20 ISBP
\textsuperscript{284} section 21 of ISBP
\textsuperscript{285} section 25 of ISBP
\textsuperscript{286} sections 28-33 ISBP
\textsuperscript{287} sections 37-40 ISBP
\textsuperscript{288} sections 170-180 ISBP
\textsuperscript{289} UCP 600, Article 13 (b): ‘[i]f a credit does not state that reimbursement is subject to the ICC rules for bank-to-bank reimbursements, the following apply: (…)
\textsuperscript{290} Introduction to URR 725
\textsuperscript{291} URR 725 , Article 1
2.2.7. United Nation’s Convention on Independent Guarantees and Standby Letters of Credits

UNCITRAL Convention has been drafted by an intergovernmental organization which is body of United Nations General Assembly and works on preparation of instruments for harmonization of law regarding international trade. Convention has been adopted by UN General Assembly on 11 December of 1995. Standby letters of credits and independent guarantees or any other international undertaking can be subjected to the UCITRAL Convention:

“the place of business of the guarantor/issuer at which the undertaking is issued is in a Contracting State,” or “the rules of private law lead to the application of the law of a Contracting State,” “unless the undertaking excludes the application of the Convention.”

In case of Commercial Letters of Credit, by express address of parties to the credit UNCITRAL Convention can be used as the governing law. Although, UCP and URDG have been used as bases for drafting the UNCITRAL Convention, it is possible to distinguish some differences among them. First, UCP and URDG have been drafted by ICC which is a private institute and its approvals might only have application as voluntary rules or self-regulations while UNCITRAL Convection is a uniform law and official regulation applied to signatory countries which has been drafted by an international organization. Therefore, UNCITRAL Convention can be differentiated from ICC rules due to its legal statues. In addition, UNCITRAL Convention, consist of complementary provisions to UCP 600, URDG and ISP 98 including abusive demand, fraud and remedies which are discussed under the section 19 of Convection.

2.2.8. Unified Commercial Code

Among the common law jurisdictions, United States of America is the only country which a detailed regulation on Documentary Letters of Credits under the Article 5 of UCC: “The U.C.C. is a collection of model statutes drafted and recommended by the National Conference of Commissioners of Uniform State Laws (NCCUSL) and the American Law Institute (A.L.I.) for enactment by the legislatures of the states of the United States. It consists of eleven different articles, each covering a different aspect of commercial law.” Article 5 of the UCC was drafted for the

293 Gao X & Buckley RP (2003) .117
294 UNCITRAL CONVENTION art. 1(2)
295 UNCITRAL CONVENTION art. l(1)(b).
296 UNCITRAL CONVENTION art. 1(2)
first time during 1950s when it was intended to act as an “independent theoretical framework for the further development of letters of credit.” Article 5 of UCC was revised in 1995 almost after forty years of hard use in order to overcome “weaknesses, gaps and errors in the original statute which compromise its relevance”. The revised Article 5 of UCC which was completed in October 1995 and it was almost adopted by all states in 2002. Despite the presence of Article 5 of UCC, still UCP has great influence of American regulations of Documentary Letters of Credits. According to the official commentary to article 5: “Article 5 of UCC and UCP are consistent and complementary to UCP in many occasions”. However, they have substantial differences as well. Firstly, Article 5 of UCC has been drafted as a Statue while neither ICC regulation including UCP have such effect. Secondly, in accordance with UNCITRAL Convention, article 5 comments on fraud rule which has been left open by UCP.

**National Laws**

There are few counties expect the United States of America which enjoy the national statutory provisions on Documentary Letters of Credit. Among them Greece was the first country to adapt such law in 1923. Italy is the other European country which regulates LC operation under article 1530 of its Civil Code by defining rights of account party and beneficiary. It also clarifies bank’s rights and obligations. Some South Amirian counties including Bolivia, Colombia, Guatemala, Honduras, Mexico and El Salvador also have their own national statute for regulating LC operation. In the Middle East, most of countries are influenced by Lebanese Law and Kuwaiti Law. Lebanese Law which is followed in Qatar and Syria regulates operation of Documentary Letters of Credit under article 313 of its Commercial Code. Kuwaiti Law which is adapted in Iraq and Bahrain is the most comprehensive and modern statutory law of Documentary Credits which covers areas of expiry date, transfer and assignment of the credit.

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298 Gao X & Buckley RP (2003), 117
300 Task Force on the Study of U.C.C. Article 5, Report, An Examination of U.C.C. Article 5 (Letters of Credit), 45 Bus. LAW 1521, 1532 (1990)
306 Article 348 of Civil and Commercial Code of 1971
308 Law Number 304 of 1942.
309 Article 273-284 of the commercial code, Law Number 30 of 1984.
confirmation, fraud, duty of examination of documents by bank, definition of comprehensive presentation and autonomy principle under its articles.

Conclusion

The development of letter of credit goes back to the demand of mercantile practice in the course of time. There is no doubt about similarities between legal characters of Letters of Credits, Negotiable Instruments and Contracts, however, unique nature of their Jurisprudence should not be confuses with the latter.

As a result, all involved practitioners in the area of international trade law and international trade finance should keep in mind similarities and differences between Letters of Credits and other financial Instruments. Legal nature of Letters of Credits are covered mostly in the framework of Unified Customs and Practices for Documentary Letters of Credits (UCP), eUCP, URCG, URDG, ISP98, UNCITRAL Convention, ISBP and Uniform Rules for Bank to Bank Reimbursement under Documentary Credits. In United States of America, Article 5 of the UCC governs legal aspects of Documentary Letters of Credit Operation. Additionally, matters related to principles of strict compliance and autonomy as well as exceptions to autonomy principle are covered mostly by domestic law of respective jurisdiction. This can be considered as the most important difference between legal nature of Documentary Letters of Credit, Negotiable Instruments and Contracts which should be kept in mind by all legal practitioners involved in Letter of Credit Operations.

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6.7. DOCUMENTARY LETTERS OF CREDIT, PRINCIPLE OF STRICT COMPLIANCE AND RISK OF DOCUMENTARY DISCREPANCY

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Abstract

Documentary Letters of Credit are considered as life blood of international trade. Their importance becomes evident when two businessmen from different parts of the globe who have no knowledge about each other’s financial and business history decide to do trade together. In such an occasion, Documentary Letters of Credit facilitate the trade process by shifting commercial risk of non-payment from importer to irrevocable promise of payment by a bank under the condition of presenting complying documents required in LC by exporter. However, some research indicate that more than 70 percent of presentations of exporter beneficiaries are dishonored by banks due to documentary discrepancy. Corner stone to current paper is Principle of Strict Compliance in LC operation which is regulated under article 14 of Uniform Customs and Practices for Documentary Letters of Credits published by ICC (latest version is UCP 600). In analyzing the legal character of Principle of Strict Compliance, paper will try to answer the question of (i) What are standards of compliance in decisions of English, American and South Korean courts in determining discrepancy of presented documents to bank? (ii) How different are these standards and what are main types of documentary discrepancy in international LC transaction?

1. Introduction

In R.D. Harbottle (Mercantile) Ltd v. National Westminster Bank Ltd, Documentary Letters of Credit were named as “life blood of international commerce”. They are among the most preferred methods of payment in international business due to their very particular characteristic. Professor Roy Goode defines Documentary Letters of Credits as: “A money promise which is independent of the transaction that gives it birth and which is considered binding when received by the beneficiary without acceptance, consideration, reliance, or execution of solemn form”. Enonchong introduces four generic functions for the Letter for Credits. First, Letter of credit reduces commercial risk both for importer and exporter by providing security of payment for exporter and security against the non-delivery of goods for importer. Second is providing finance for importer and helping him with cash flow while at the same time providing exporter with the chance to raise money before being

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313 Goode.R, ‘Abstract Payment Undertakings’ in Peter Cane and Jane Stapleton (eds), Essays for Patrick Atiyah (OUP 1991)
paid by issuing bank. Third, Documentary Credits can be used as security for other obligations like case of Back-to-Back letter of credits. Fourth, is the function of documentary credits as conditional payment method and providing the possibility for seller to receive payment from importer in case the credit has been dishonoured by bank.

Functions of Documentary Letters of Credit operation follows different steps of the LC process\(^{315}\). Process starts with negotiation of the terms of contract by buyer and seller. They will enter the underlying contract of sales. According the underlying contract, exporter will undertake to provide confirming goods which are subjected to that particular transaction and importer commits to pay the price of good via Documentary Letter of Credits.

Further, information regarding the details of the Credit will be also mentioned in the underlying contract. As the second phase, buyer will require the issuing bank to open a credit in favour of exporter. In case of issuing bank’s agreement to issue the credit, Importer (account party) and issuing bank enter into a contract in which account party commits to reimburse the issuing bank for payment to the exporter (beneficiary) as well as paying relevant banking fees\(^{316}\). Then, issuing bank will contact beneficiary and inform him about terms of credit and enter into a contract with beneficiary to pay him price of goods sold to the importer in return of delivering confirming documents stipulated in the credit\(^{317}\). Although, these three independent contracts are considered as basic framework for function of Documentary Letter of Credits, but in practice, in majority of occasions, beneficiary will interact with a local bank in his own country rather than being directly involved with issuing bank. If parties decide so, then the advising bank will contact the beneficiary in order to inform him about the issuing of the credit in his favour. At the time that credit requires involvement of Nominated Bank and Confirming Bank, there will be a separate contract between Beneficiary and Nominated or Confirming Bank and Issuing Bank and Nominated and Confirming Bank. Advising Bank might or might not accept to act in the capacity of Nominated and/or Confirming Bank.

As a result, beneficiary ships goods for account party and provides confirming stipulated documents in the credit to the issuing bank, Nominated Bank or Confirming Bank. Confirming Bank will check presented documents and in case of conformity, it will pay beneficiary based on the authorisation in issuing bank, transfer documents to issuing bank and wait for reimbursement\(^{318}\). Issuing bank also checks documents and in case of their conformity will reimburse Nominated or Confirming Bank, debit the account of applicant and inform him to come and receive his documents.

\(^{315}\) Ibid, p.8,


\(^{317}\) Article 7- UCP 600

\(^{318}\) Article 7(C), UCP 600.
As it was mentioned earlier, most of the time credit will require the involvement of Nominated Bank and Confirming Bank as Issuing bank is not located in country of Beneficiary and it is difficult for him to confirm the authenticity of signatures by issuing bank.\textsuperscript{319}

For the purpose of protecting the flow of international trade and safeguarding the operation of Documentary Letters of Credits, they are subjected to two main principles of Strict Compliance and Autonomy. This paper will focus on main principles of Documentary Credits under the English Law and discuss the exceptions to the principle of autonomy at the end of the chapter.

2. Principle of Autonomy

First fundamental principle in operation of letters of credit is Principle of Autonomy. This principle has been appreciated by national and international legal frameworks.\textsuperscript{320} The principle of autonomy of letters of credit has been considered as “cornerstone of the commercial validity of the letters of credit”\textsuperscript{321}, and “the engine behind the letter of credit”\textsuperscript{322}. The autonomy principle of letter of credits has been clearly mentioned in article 4 of UCP 600:

\textbf{“Article 4 Credits v. Contracts}

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.

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 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 performance of underlying contract.

\textsuperscript{319} Längerich, R.(2000),104

\textsuperscript{320} 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

\textsuperscript{321} Ward Petroleum Corp. v Federal Deposit Ins. Corp. (1990) 903 F.2d 1299.

\textsuperscript{322} Arkins J (2000) 31
Therefore, even in cases of argument on performance of underlying contract account party and issuing bank have no other choice rather than paying beneficiary upon presentation of complying documents and seek remedy by suing him for the breach of underlying contract. As a result, Autonomy Principle has been considered a means of promoting international trade by following the logic of “pay first, argue later.”

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 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. That system of financing would break down completely if a dispute between the seller and buyer was to have the effect of “freezing” the sum in respect of which the letter of credit was opened.”

In order to completely address the essence of 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.”

3. The Principle of Strict Compliance

The principle of Strict Compliance is second fundamental principle of Letter of Credit operation and cornerstone to current research paper. It emphasizes that issuing bank’s undertaking to honour the credit is effective only upon presentation of complying documents which are stipulated in the credit by beneficiary. 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 principle if he acts in accordance with his instructions.” 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:

326 UCP600. Article 5
327 Interalia Article 2; Article 7(a), Article 8(a)(c) and Article 15 ; Article 14 and Article 34 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.

b) 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 data\(^\text{329}\), discrepant documents of transport\(^\text{330}\), mistakes in draft\(^\text{331}\), drafts without signature and inconsistent invoice with credit\(^\text{332}\), and documents with wrong signature\(^\text{333}\).

In fact, contrary to the principle of independence, 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 about what constitutes the complying presentation which can be traced into legal cases\(^\text{334}\). The most important question can be what is the characteristic of non-complying presentation?\(^\text{335}\)

There are two main theories regarding the determination of documentary compliance:
Doctrine of Strict Compliance and Doctrine of Substantial Compliance\(^\text{336}\).

3.1. **Doctrine of Strict Compliance**

According to the doctrine of Strict Compliance, presented documents should strictly comply with credit\(^\text{337}\). In contrary with UCP 500, the term of “Reasonable Care” has been deleted from UCP 600 which shows that only strict compliance

\(^{329}\) Article 14(d) UCP 600
\(^{330}\) Article 19 UCP 600
\(^{331}\) Article 18(c) UCP 600
\(^{332}\) Article 28 UCP 600
\(^{333}\) Article 34 UCP 600
\(^{334}\) Botosh HMS ‘Striking the Balance Between the Consideration of Certainty and Fairness it the Law Governing Letters of Credit’ (2000) 183-271
\(^{336}\) Ibid
\(^{337}\) Ibid
is the criteria for reimbursement of bank by applicant. However, word by word compliance or mirror image of data between LC and required documents is not be required by UCP 600\textsuperscript{338}. 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 errors\textsuperscript{339}. However, it is difficult to distinguish the insignificant error from the significant one. For example in Seaconsar Far East Ltd V. Bank Markazi Jomhouri Islami Iran\textsuperscript{340}, credit defined all documents should bear the credit number and buyer’s name. However, one of the tendered documents missed the buyer’s name and credit number. The Lloyd LJ held that bank was entitled to reject the presentation\textsuperscript{341}:

“[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, according to Doctrine of Strict Compliance, discrepancies can be 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 bank.

3.1.1. Irrelevant Irregularities

Except in case of Commercial Invoice, UCP 600 does not require for strict compliance of any documents with Credit. In fact, some articles provide tolerance up to 10 percent regarding ‘amount or quantity of credit while terms like ‘about’ or ‘approximate’ are uses in the credit\textsuperscript{342}. Other articles provide tolerance of 5 percent when quantity is not defined in the credit.\textsuperscript{343}

3.1.2. Material Discrepancy

There are numerous cases on material discrepancies. In JH Raynor & Co. Ltd v. Hambro’s Bank Ltd\textsuperscript{344}, shipped goods were described in the bill of lading as “machine-shelled ground kernels”, however, credit had the description of goods

\begin{itemize}
\item \textsuperscript{338} Wood JS (2008) 106
\item \textsuperscript{339} Ibid
\item \textsuperscript{340} Seaconsar Far East Ltd V. Bank Markazi Jomhouri Isami Iran [1993] 3 W.L.R. 756 (HL), [1993] 1 Lloyd’s Rep. 236 (CA)
\item \textsuperscript{341} Ibid
\item \textsuperscript{342} UCP600, Article 30 (a)
\item \textsuperscript{343} UCP 600, Article 30 (b)
\item \textsuperscript{344} JH Raynor & Co. Ltd v. Hambro’s Bank Ltd [\textsuperscript{9Q3}] Q.B. 711
\end{itemize}
as “Coromandel groundnuts”. In the judgement of court of appeal, it was held that bank was correct about rejection of tender despite the fact that terms were proved to be the same. As, bank is not required to have the knowledge of the meaning of terms in different fields.\textsuperscript{345}

Other example is \textit{Courtaulds North America, Inc. v. North Carolina Nat. Bank}\textsuperscript{346} which will be discussed later in more details. In this case, credit required an invoice for ‘100\% Acrylic Yarn’ while the presented invoice described goods as ‘Imported Acrylic Yarn’. Bank rejected the presentation\textsuperscript{347}. The court held that bank was entitled to dishonour presentation despite the fact that description of goods on packing list were matching with credit on the basis that UCP has differentiated invoice from remaining documents.\textsuperscript{348}

“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.”\textsuperscript{349}

\textit{Bank Melli Iran v. Barclays Bank (Dominion, Colonial & Overseas)}\textsuperscript{350} is another important case on material discrepancies. In above mentioned case payment was due upon presentation of commercial invoice for shipment of ‘100 new Chevrolet trucks’ while invoice described goods as ‘in new condition’. The court held that bank was entitled to reject presentation as ‘in the new condition’ and ‘new’ are not the same.\textsuperscript{351}

\section*{3.2. Substantial Compliance}

The requirement of test is that banker should “look beyond the face of the documents, investigate the realities of the transaction, and weigh the credibility of documents, customers and beneficiaries”.\textsuperscript{352} 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 services.\textsuperscript{353}

\begin{footnotes}
\item[345] Ibid
\item[347] Ibid, 896
\item[348] Article 14(e) UCP 600, which reads ‘documents other than the commercial invoice’
\item[349] Courtaulds North America, Inc. v North Carolina Nat. Bank 528 F.2d 802, C.A.N.C [1975] 806
\item[350] Bank Melli Iran v Barclays Bank (Dominion, Colonial & Overseas) [1951] 2 Lloyd’s Law Reports 367.
\item[351] Ibid
\item[353] UCP 600, Article 5.
\end{footnotes}
4. Examination of Documents

UCP 600 emphasizes that bank has duty of examining tender of documents by beneficiary in order to confirm its compliance with terms of credit on the basis documents alone. Documents will be examined on their face and their compliance will be determined against provisions of UCP and ISBP (International Standard Banking Practice). "A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank shall each have a maximum of five banking days following the day of presentation to determine if a presentation is complying. This period is not curtailed or otherwise affected by the occurrence on or after the date of presentation of any expiry date or last day for presentation."

ICC provides explanation of examining documents as “appear on their face”: “… the decision as to whether the documents do or do not comply with the terms and conditions of the credit and are consistent with one another is based exclusively upon the banker’s examination of the document, and not upon someone else’s understanding. In other words, there is a method for examination of documents under the documentary credit which is peculiar to bankers. This method attempts to find whether certain statements, terms or conditions appear on the document. The phrase “on their face” is not to be interpreted as meaning either the “face” or the “reverse” of the document." Court of Southland Rubber Co Ltd v Bank of China confirms this view by holding: “… the obligation placed upon the bank is not an unqualified obligation to determine whether the documents are correct but to determine whether they “appear, on their face” to comply with the terms of the credit. In fulfilling this function, a bank is not required to look at each set of documents presented for payment with microscopic scrutiny or as if it is embarking on a fault finding mission. Equally so a bank is not required to engage itself in a speculation or guessing exercise either."

4.1. Possible Outcomes of examining presentation by bank

In case of tender of complying documents by beneficiary, bank has the mandate to honour the credit. However, UCP provides guidance for bank on how to treat presentation when it does not strictly comply with terms and conditions of credit. Bank might choose either to reject the non-complying presentation or approach
applicant for waiver\textsuperscript{361}. Former version of UCP (UCP 500) provided two more options for bank to make payment against beneficiary’s indemnity or keeping the right to recourse against resulting any loss because of discrepant presentation\textsuperscript{362}. However, they were not incorporated in UCP 600 which might be due to not being practiced popularly.

Mann comments on popularity of the practice of seeking waiver for discrepancies from applicant\textsuperscript{363}. In his study on discrepancies in 500 Letter of Credit presentations to American banks, he found only one case of discrepant presentation not receiving waiver by applicant\textsuperscript{364}. In approaching applicant for a waiver of discrepant presentation, bank acts on its sole judgement\textsuperscript{365} and within the period of five banking days defined by UCP for examination of documents\textsuperscript{366}. Bank should approach applicant to seek a waiver after finding discrepancies regardless to request of beneficiary\textsuperscript{367}. In approaching applicant for a waiver, bank might or might not grant applicant with access to documents or not. Accordion to decision of the court of Bankers Trust Co v State Bank of India\textsuperscript{368} releasing documents to applicant by bank should be only for the sake of facilitating decision of the applicant on whether to give waiver or not. Granting applicant with access to documents for the purpose of checking them or finding further discrepancies can result losing the right for rejection by issuing bank\textsuperscript{369}.

While facing with discrepant presentation, bank can also refuse to negotiate or honour the presentation\textsuperscript{370}. In rejection of discrepant tender of documents, bank should give a single notice of rejection to presenter\textsuperscript{371}. Logic behind issuing a rejection notice is based on the objective of informing beneficiary or paying bank about reason for rejection and letting them to correct discrepant documents as soon as possible\textsuperscript{372}. Also presenter will have chance to seek justice against invalid and unjustified grounds for rejection of tender by bank\textsuperscript{373}. According to article 16 of UCP 600, a proper rejection notice should include: Clear statement of bank to

\textsuperscript{361} UCP 600, Article 16 (b).
\textsuperscript{362} UCP 500, Article 14 (f).
\textsuperscript{364} Ibid
\textsuperscript{365} UCP 600, Article 16 (b).
\textsuperscript{366} UCP 600, Article 14 (b).
\textsuperscript{369} King Tak FUNG (2004) Leading Court Cases on Letters of Credit, ICC Publication 658, 84-85
\textsuperscript{370} UCP 600, Article 16 (c)
\textsuperscript{371} Ibid
\textsuperscript{372} King Tak FUNG (2004) Leading Court Cases on Letters of Credit, ICC Publication 658,115
\textsuperscript{373} Ibid
refuse honour or negotiation of credit\textsuperscript{374}. In this regard, bank should specify each discrepancy which is the basis for decision to reject honouring presentation\textsuperscript{375}. In case bank’s failure to list all detected discrepancies, there will not have chance to issue the second rejection notice and list missing discrepancies as a reason for rejection\textsuperscript{376}. Finally, notice of rejection should include decision of bank on what is going to happen to presented documents. Whether documents will be held by bank waiting for further instructions by presenter\textsuperscript{377}, returning documents\textsuperscript{378}, bank will hold documents up to the time of receiving waiver from applicant\textsuperscript{379}, “or acting in accordance with instructions previously received from the presenter\textsuperscript{380}”.

Proper notice of rejection should be delivered to beneficiary by telecommunication or any other means before end of five banking days\textsuperscript{381}. Oral rejection will be permitted only in case that “if a senior official of the beneficiary (or the remitting bank, as the case may be), under whose aegis the documents were presented, is present at the bank to receive notice”\textsuperscript{382}.

4.2. Categories of Documentary Discrepancy in Letter of Credit Operation and Relevant Court Orders

The majority of discrepancies in practice of Documentary Letters of Credit include inconsistent data\textsuperscript{383}, discrepant documents of transport\textsuperscript{384}, mistakes in draft\textsuperscript{385}, drafts without signature and inconsistent invoice with credit\textsuperscript{386}, and documents with wrong signature\textsuperscript{387}. However, it will be more practical to study discrepancies in case of categorize those under three main groups of: Typing errors and misspellings, discrepant dates and relevant discrepancies on commercial invoice.

Due to importance of court’s capability to constitute grounds for dishonouring presentation by bank as result of documentary discrepancy\textsuperscript{388}, there is need for

\textsuperscript{374} UCP 600, Article 16 (c ),(i)
\textsuperscript{375} UCP 600, Article 16 (c ),(ii),
\textsuperscript{376} King Tak FUNG (2004) Leading Court Cases on Letters of Credit, ICC Publication 658, 85
\textsuperscript{377} UCP 600, Article 16 (c ),(iii), (a)
\textsuperscript{378} UCP 600, Article 16 (c ),(iii), (c )
\textsuperscript{379} UCP 600, Article 16 (c ),(iii), (b)
\textsuperscript{380} UCP 600, Article 16 (c ),(iii), (d)
\textsuperscript{381} UCP 600, Article 16 (d)
\textsuperscript{382} Seaconsar (Far East) Ltd v Bank Markazi Jomhouri Islami Iran (Documentary Credits), [1999] 1 Lloyd’s Rep. 36, at 36.
\textsuperscript{383} UCP 600, Article 14(d)
\textsuperscript{384} UCP 600 ,Article 19
\textsuperscript{385} UCP 600, Article 18(c)
\textsuperscript{386} UCP 600 ,Article 28
\textsuperscript{387} UCP 600 ,Article 34
\textsuperscript{388} Kyle Roane (2004) Hanil Bank v. PT. Bank Negara Indonesia (Persero): Continuing the Quandary of Documentary Compliance under International Letters of Credit, Copyright (c) 2004 Houston Law Review, 31
uniform standard regarding documentary compliance in Letter of Credit operation. Unfortunately, in absence of such standard, English courts either use doctrine of strict compliance or doctrine of Substantial Compliance. While both doctrines have their supporters and critics among scholars movement towards a clearer requirement for compliance can be witnessed in every revision of UCP. Access to such clear requirements of compliance will help beneficiaries to face less with rejection rate by bank as a result of discrepant presentation and also banks will have more secure and effective document examination process. This part of research will focus on most important categories of documentary discrepancy and the method which court chose in treating them.

4.2.1. Typing errors and misspellings

Preparation of different documents by different people in the process of LC operation makes it vulnerable to typing errors, misspellings and missions. Such problems can be considered as discrepancy in while examining presentation by bank if they are relevant with credit requirements. UCP takes silent position towards misspelling and typing errors, however, it is provided by paragraph 25 of ISPB 2007 that “a misspelling or typing error that does not affect the meaning of a word or the sentence in which it occurs does not make a document discrepant. For example, a description of the merchandise as “mashine” instead of “machine”, “fountan pen” instead of “fountainpen” or “modle” instead of “model” would not make the document discrepant. However, a description as “model 123” instead of “model 321” would not be regarded as a typing error and would constitute a discrepancy”.

Before publication of ISBP, in absence of relevant rules to typing errors and misspellings, courts had absolute discretion in defining standard of proof for discrepant presentation. In current section, some important legal cases in this field will be analysed in order to show different approaches of courts to the subject matter.

In Beyene v. Irving Trust Co., name of applicant was mentioned as “Mohammed Sofan” in the Credit while bill of lading was issued to “Mohammad Soran”. In rejection of the presentation by confirming bank, court considered misspelling as material discrepancy and ruled in favour of confirming bank to reject the presentation. In the process of ruling, court developed two standards: 1) is the misspelling obvious or not? Bank will be entitled to reject the presentation if misspelling is not obvious. Cases like typing “Smith” as “Smithh” is an obvious misspelling which does not provide bank with grounds to reject the presentation. 2) Is misspelling inconsequential? Bank will not be authorised to dishonour the tender of documents if misspelling is not obvious but at the same time it does not have negative effect on either involved party in LC operation.

While comparing the court decision with Article 14 (j) of UCP 600, probably the outcome of would be similar if it was decided at present. Additionally, misspelling of “Mohammed Sofan” as “Mohammad Soran” is discrepancy on the basis of paragraph 25 of ISBP as they might be two different people.

In Bank of Cochin Ltd. v. Manufacturers Hanover Trust Co confirming bank was sued by issuing bank for wrongful honouring of a LC against presentation of discrepant documents. Main discrepancies were defined as negotiating LC to St. Lucia Enterprises when beneficiary was stated as St. Lucia Enterprises Ltd in the credit. Second discrepancy was cable of the St. Lucia Enterprises Ltd to her insurance company which was wrongfully stating the insurance cover note number of 429711 as 4291393. While the case was in fact an obvious fraud in which no goods were shipped to the applicant and beneficiary was disappeared court decided to use the second standard of Beyene v. Irving Trust Co, and decide on the basis that “whether or not the misspelling was inconsequential”. Both misspellings were considered as discrepancy since difference in names was material and sign of forgery while misspelling in insurance coverage number could result in refusal to honour the insurance policy by insurance company. Since both misspellings affect the meaning of the word, on the basis of paragraph 25 of ISBP, they would be also considered as discrepant.

In case of Hanil Bank v. PT. Bank Negara Indonesia (Persero) on the basis of the request of applicant from BNI to issue a Letter of Credit in favour of “Sung Jun Electronics Co., Ltd”, LC was issued while beneficiary’s name misspelled as “Sung Jin Electronics Co. Ltd”. After negotiating the credit, presentation of negotiation bank (Hanil Bank) was rejected by issuing bank on the basis of document discrepancy. Court referred to the case of Beyene v. Irving Trust Co and by considering misspellings as similar in both cases commented that Hanil Bank could not expect that Sung Jun is the same as Sung Jin. However, instead of referring to the second standard of Beyene v. Irving Trust Co, court referred to article 13 of UCP (500) as “the bank looks solely at the letter and documentation the beneficiary presents to determine whether the documentation

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391 “… when the address and contact details of the applicant appear as part of the consignee or notify party details on a transport document … they must be as stated in the credit”

392 Cochin Ltd. v. Manufacturers Hanover Trust Co 612 F.Supp. 1533, D.C.N.Y., 1985

393 Ibid, 1536

394 Ibid, 1534


396 Cochin Ltd. v. Manufacturers Hanover Trust Co 612 F.Supp. 1533, D.C.N.Y., 1985 ; 1541

397 Ibid


399 Ibid , p.1


401 Hanil Bank v. PT. Bank Negara Indonesia (Persero) ,2000 WL 254007 (S.D.N.Y.), p.4
meets the requirements in the letter”. As a result, court ruling was in favour of BNI for rejection of discrepant presentation402.

In South Korean Hyosung Corp. v. China Everbright Bank (Xiameng Branch)403 name of beneficiary was mentioned as KOMHO CHEMICALS CO., LTD, but packing bill/weight bill was showing the name as KOMHO CHEMICALS, INC. Issuing bank refused to honour the presentation on the basis of discrepant presentation. In confirming the entitlement of bank to dishonour the presentation, court referred to the first test of Beyene v. Irving Trust Co, and clarified that INC cannot be Ltd or Co, therefore, misspelling is not obvious. However, instead of using the second standard, court used Article 13 (a) of UCP 500 but unlike the case of Hanil Bank v. PT. Bank Negara Indonesia (Persero)404 and reference to mirror image rule, the preference was towards application of paragraph 25 of ISBP and using the test of “whether the misspelling could lead to another meaning”405.

4.2.2. Mistakes in Commercial Invoice

Commercial invoice is one of documents which should accompany all goods sold under Documentary Letters of Credit. Therefore, it is of crucial importance for content of commercial invoice to be regulated clearly. Currently, Article 18 of UCP 600 is regulating compliance issues in commercial invoice under LC operation as “the description of goods, services or performance in a commercial invoice must correspond with that appearing in the credit”. ISBP also comments that: “there is no need for a mirror image. For example, details of the goods may be stated in a number of areas within the invoice which, when collated together, represent a description of the goods corresponding to that in the credit”406. However, it is necessary to bear in mind that before publication of ISBP in 2003, different visions of UCP were the only reference for defining the compliance of commercial invoice with content of the Letter of Credit. It would be interesting if we review legal cases regarding discrepancy in commercial invoice in order to define under which conditions courts used doctrine of Strict Compliance and when did they prefer to apply the doctrine of Substantial Compliance.

Bank Melli Iran v. Barclays Bank (Dominion, Colonial & Overseas)407 is one of the important cases regarding application of doctrine of Strict Compliance to discrepancies in Commercial Invoice. The court was considering allegation

403 South Korean Hyosung Corp. v. China Everbright Bank (Xiameng Branch) Civil Judgement (2003) Min Jing Zhong Zi Bo. 069; Fujian High People’s Court [China]
404 Hanil Bank v. PT. Bank Negara Indonesia (Persero) 2000 WL 254007 (S.D.N.Y.)
of issuing bank that payments have been effected by confirming bank against discrepant commercial invoice when LC has described goods as 100 New Chevrolet Trucks, but Commercial Invoice refers to Chevrolet Trucks as in New Condition\textsuperscript{408}. Referring to the Doctrine of Strict Compliance, court held that “in new condition” is not the same as “new” and therefore, commercial invoice is discrepant\textsuperscript{409}.

In \textit{Courtaulds North America, Inc. v. North Carolina Nat. Bank (North Carolina, USA, 1970)}\textsuperscript{410} the commercial invoice describing goods as “Imported Acrylic Yarn” while the Credit requirement was “100% Acrylic Yarn”. Issuing bank refused to make the payment and by referring to standard of compliance defined in \textit{Equitable Trust Company of New York v. Dawson Partners, Ltd}\textsuperscript{411} court ruled that “Free of inaptness 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”\textsuperscript{412}. Court rejected the discretion of goods on packing lists as “100% Acrylic” sufficient for compliance of invoice as UCP has made clear distinction between Commercial Invoice and other accompanying documents\textsuperscript{413}.

In \textit{Sunlight Distribution, Inc. v. Bank of Communications (New York, USA, 1995)}\textsuperscript{414} Letter of Credit was issued for sale of: “MOTOROLA8900X-2 (ETACS) PORTABLE RADIO TELEPHONE, 2600 UNITS”\textsuperscript{415}. However, bank rejected payment to beneficiary due to description of goods in commercial invoice which has an extra prefix of “S3410A” as well as additional descriptions including “SNN404A BATTERY BLACK HICAP”, “SNN4216A PROGRAMMING BATTERY FOR 8900X-2” and “SNN4216A BATT TEST A/P SAM”\textsuperscript{416}. Subjected to the UCP 400, article 41(c) was regulating compliance in commercial invoice in similar manner to article 18 (c) of UCP 600. The court ruled in favor of issuing bank by making reference to Dolan’s opinion on Article 41 (c) of UCP 400: “it is a well – established principle of letter of credit law that the description of the goods in the commercial invoice must mirror the description in the credit itself. … While other documents need merely describe shipments “in general terms not inconsistent with the description of the goods in the credit,” the invoice description must - much more stringently - “correspond” with that of the credit”\textsuperscript{417}.

\textsuperscript{408} Ibid, 372.
\textsuperscript{409} Ibid, 374.
\textsuperscript{413} Ibid
\textsuperscript{415} Ibid, 1
\textsuperscript{416} Ibid ,2
\textsuperscript{417} Ibid
The take away from above mentioned court ruling is that content of commercial invoice should be exactly mirrored from the LC. Particular attention should be given to technical terms which are expectedly unfamiliar to bankers.

*Astro Exito Navegacion S.A. v. Chase Manhattan Bank N.A., (The Messiniaki Tolmi)*\(^{418}\) was against confirming bank Chase Manhattan Bank N.A for dishonouring tender of documents as a result of documentary discrepancy and lack of conformity between data in Commercial Invoice and the LC\(^{419}\). The Credit requirements included documents of sale for “a Greek flag motor tanker, Messiniaki Tolmi ex Berger Pilot of about 20,150 long tonnes displacement with one bronze working propeller, one spare tail end shaft to arrive under own power at Kaohsiung, Taiwan, on or before September 30th 1980 as is and always safely afloat and substantially intact as per memorandum of agreement dated July 2nd 1980”\(^{420}\). However, in invoice, ship was called “previous” instead of “ex” and following descriptions were missing: “Ex Berger Pilot to arrive under own power at Kaohsiung, Taiwan, on or before 30th September 1980, as is but always safely afloat and substantially intact as per memorandum of agreement dated 2nd July 1980”\(^{421}\). The Court referenced to article 32 (c) of UCP 290 and held that: “(Article 32 (c)) suggests that correspondence in description requires all the elements in the description to be present, although the article does not say that the description in the invoice must be the same as that in the credit”\(^{422}\). Therefore, Justice Leggatt ruled that “ex Burger Pilot” and “previous Burger Pilot” are the same object and omissions were not part of description of goods which interalia does not make the presentation discrepant and do not affect invoice’s validity\(^{423}\). In *Astro Exito Navegacion S.A. v. Chase Manhattan Bank N.A.*, court applied the doctrine of substantial compliance instead of strict compliance by disregarding necessity for including specific descriptions of sales item in the commercial invoice.

*Glencore International AG & Anor v. Bank of China*\(^{424}\) is another case in which court used doctrine of substantial compliance. While the Credit required description of goods as “any western brand”, commercial invoice described them as “any western brand – Indonesia (Inalum Brand)”. In the same manner like *Sunlight Distribution, Inc. v. Bank of Communications*\(^{425}\), the commercial court ruled in favour of rejection.

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\(^{419}\) Ibid, p. 455

\(^{420}\) Ibid, p.458

\(^{421}\) Ibid

\(^{422}\) Ibid

\(^{423}\) Ibid


of presentation by bank while considering “any western brand – Indonesia (Inalum Brand)” as specific term which bank is not obliged to be aware of. However, the Court of Appeal, reversed the judgment and held that “it is … plain that the origin specified in the credit (“any western brand”) is expressed in a very broad generic way. A banker would require no knowledge of the aluminium trade to appreciate that there could be more than one brand falling within the genus. … We cannot for our part accept that the additional words “Indonesia (Inalum brand)” were such as … to call for further inquiry or are such as to invite litigation. It seems to us quite plain on the face of the document that the additional words were to indicate the precise brand of the goods, it being implicit that that brand fell within the broad generic description which was all that was required. The additional words could not, on any possible reading of the documents, have been intended to indicate that the goods did not or might not fall within the description “any western brand”426. Further, court referenced to discussions over UCP: “Certain National Committees recommended that the word “correspond” be replaced with “identical” in respect to the description of the goods appearing in the commercial invoice versus that of the credit. The Working Group felt that the word “identical” was too restrictive and would place an undue burden on all the parties to the documentary credit and increase the number of discrepant invoices presented. At times additional information is supplied in the description of the merchandise appearing in the commercial invoice. This additional information may not be considered detrimental or inconsistent with the requirements in the credit and therefore it is acceptable”427. As a result, the Court of Appeal reversed the judgement of Commercial Court and in contrary with the case of Sunlight Distribution Inc. 428 by applying doctrine of substantial compliance, did not consider additional information on the commercial invoice as discrepancy429.

The South Korean Supreme Court Decision 2003Da63883 delivered on June 11, 2004 clearly defines the basis for application of principle of Strict Compliance in South Korea. The case is about refusal of issuing bank to effectuate third payment under the LC for sales of fish where description of product mentioned in the commercial invoice did not comply with terms of credit. With reference to article 13(a) of UCP (500) court held : “On the basis of the facts found by the court below, compare the third L/C (No.: M1412707NS00228) with the commercial invoice for the first and second shipping, presented on the basis of the above L/C, which the plaintiff disputes in the grounds appeal, we hold as follows. (1) “Hair Tail,” “Yellow Convina, White Convina,” “Chub Mackerel,” “Cod,” “Eastern Flat Head,” described in the product description of the commercial invoice for the first shipping, cannot be deemed to be in accord either with “OTHER KIND OF FISH (unit price $2,800)” described in the L/C, because they are all “$2,200” in unit price. (2) On the other hand, the products with the value of $2000 and

listed in the list of products described in the above L/C is “TOP SHELLS AND OTHERS.” Because the literal translation means “top shells and others” and there is a description “OTHER KIND OF COST” in the above L/C, it is appropriate to interpret “OTHERS” here as “those similar to top shells, i.e., shellfishery.” “Hair Tail,” “Yellow Convina, White Convina,” “Chub Mackerel” “Cod,” “Eastern Flat Head” are all fishery, and therefore cannot be regarded as “Others” in “Top shells and others.”

Later, court with reference to article 37 (c) of UCP 500 (Commercial Invoice) dismissed the case and held: “Products can be received only in exchange for the bill of lading (B/L), and only one B/L is issued for a commercial invoice. Therefore, where the condition of the L/C and the product description of the commercial invoice are consistent with some products but not with others, the issuing bank should deny payment of the entire amount, and may deny payment in part.

Where the presented shipping documents did not comply with the conditions of the L/C in part, and therefore the opening bank should have denied payment of the whole L/C amount, but the opening bank nevertheless paid the price, the opening bank should bear the risk and cannot claim reimbursement of the L/C amount from the L/C applicant.

The ground of appeal is that in such a case, the plaintiff can claim from the defendant reimbursement of the payment of the price corresponding to the part that complies with the condition of the L/C, which is however an arbitrary opinion and therefore cannot be accepted.”

4.2.3. Discrepancy in dates

According to Article 14 (d) of UCP 600: “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”. This applies to any sort of data on the face of documents required by the Credit including discrepant dates. Interestingly, high rate of discrepancy in dates mentioned on the face of documents required in LC operation has been found by SITPRO among frequent reasons for documentary discrepancy in International LC operation.

In Voest-Alpine International Corporation v. Chase Manhattan Bank, N.A. (New York, USA, 1982) the credit required following documents: Certificate

430 South Korean Supreme Court Decision 2003Da63883
431 Ibid
of inspection with indication of date of shipment, Bill of Lading which shows shipment of goods has taken place by latest January 31, 1981 and weight certificate of a third party inspector. In contrary with bill of lading which was evidencing shipment by January 31, 1981, other documents showed day of shipment as February 2, 1982. With reference to Article 14 (d) of UCP 290, court held that presented documents show inconsistency and bank should deny presentation as a result of discrepancy in dates. Reference to Article 14 (d) of UCP 600 which emphasizes on “not conflicting” of data in presented documents with each other shows the possibility for similar decision if it was supposed to be made at present.

However, in Breathless Associates v. First Savings & Loan Association of Burkburnett court ruled differently, by using a different standard in similar situation. In order to receive the payment beneficiary presented a promissory note dated April 29, 1983 while required date of promissory note in the Credit was clearly mentioned as April 28, 1983.

Bank rejected payment on the basis of documentary discrepancy and Sander DJ commented in court: “Manifestly, the requirement has two purposes: to limit the obligations of the issuer to examination of documents while at the same time affording the customer the greatest possible assurance that the beneficiary will not be paid (nor the customer be liable for reimbursement) unless and until the beneficiary has performed its obligations – for example, shipment by a certain date – under the underlying contract of sale. A discrepancy therefore should not warrant dishonour unless it reflects an increased likelihood of defective performance or fraud on the part of the beneficiary. In deciding this question a court should consider only what may reasonably be inferred from the face of the Documents.”

In reference to case of Voest-Alpine International Corporation v. Chase Manhattan Bank, N.A the court considered difference between dates on bill of lading and other documents as relevant to possibly of fraudulent action. However, mentioned date on promissory note did not have any importance for involved parties in LC operation. Therefore, the court considered presentation as non-discrepant and compliant with terms of credit.

435 Ibid
436 UCP 290, Article 14 (d)
439 Ibid,834.
440 Ibid,837
443 Ibid
The standard which was used by the court in this case is totally different standard from what has been discussed in current paper by considering inconsistency of data presented in documents as discrepant only under the condition that it will increase possibility for beneficiary’s fraudulent conduct. Such decision is in conflict with article 14 (d) of UCP 600 which calls for no conflict between data in presented documents with credit requirements and other documents in presentation.

5. Conclusion

Despite the fact that Documentary Letters of Credit operate in favor of reducing commercial risk in international trade, but their sole dependency of compliant tender of documents creates additional risk of dishonoring presentation by bank due to documentary discrepancy. In absence of clear standards for defining compliant tender of documents, current paper tried to review most popular types of documentary discrepancy in LC operation, different doctrines which court choose in approaching the problem of discrepant tender of documents in LC operation from perspective of English course by reviewing most important court orders in this field. As a result, paper concludes on the necessity for defining a uniform standard of proof for courts and banks in determining discrepancy in tender of documents under Documentary Letter of Credit transactions which saves money and time of involved parties in LC operation.

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Managing The Risk of Discrepancies in Documentary Letters of Credit: Study of Export DLCs in Estonia

The increasing level of export trade can be considered as a double edged sword. While it increases possibility for access to new markets and extra profit for traders, facing with expected and unexpected risks of doing business overseas would be inevitable. Among others, payment risk is substantial hindrance in closing international export contracts. This particular risk has been approached by traders via invention of different methods of payment. Documentary Letters of Credit (DLCs) are one of such methods. They are popular in export trade due to transferring the risk of payment from importer as an individual to bank as an institute with much higher financial standing. However, full documentary nature of international DLC transaction makes it vulnerable to the risk of discrepancy. As a result, instead of reducing the payment risk in export trade, DLCs can face international traders with high risk of rejection of documentary presentation by banks. Such rejection can bring about serious consequences for exporters as rectification of discrepancies might be time consuming, costly or even impossible. Therefore, outcome of rejection of documentary presentation by bank for exporter can vary from being paid with delay and need for absorption of extra costs of rectifying documentary discrepancies to incurring bad debt due to inability for rectifying discrepancies before expiry date of the credit.

The object of this research is the Enterprise Risk Management (ERM) in DLC operations. The absence of an empirical study to analyse the level of discrepancies and imposed losses resulting from it on Estonian exporting firms was the main idea behind the choice of the current research topic. In practice, this research intended to fill two main research gaps. First, according to the personal experience of the author and after conducting an extensive literature review it became evident that the Export Letter of Credit Business Risk Management model (ELCBRM model designed by Mr. Roberto Bergami) is the only ERM model describing the risk of documentary discrepancy from the perspective of exporters. However, the model is fully conceptual and does not use quantitative methods. Second, there is limited research on DLC operations in the Estonian international trade landscape and almost no public data is available regarding documentary discrepancy in Estonian export DLCs.

The study filled identified research gaps by further development of ELCBRM model of Bergami and introduction of Expanded Oriented ELCBRM model, validation of the applicability of the Expanded ELCBRM model in the context of the Estonian export landscape via conducting an empirical study, identifying the vulnerability of Estonian exporting firms to losses resulting from documentary discrepancies occurring in their DLC operations, and showing the possibility to use the Expanded Oriented ELCBRM model in different contexts for describing the use of DLCs in export trade.

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