

Users' Handbook for Documentary Credits under UCP 600

WALTER (BUDDY) BAKER AND JOHN F. DOLAN

Foreword by Donald R. Smith



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Foreword

by Donald Smith

The collaboration of an interesting authoring team, consisting of a distinguished professor of law, John Dolan, and an accomplished former international banker and current trade credit insurance executive, Buddy Baker, has resulted in a readable introduction to a sometimes complex and often confusing product—the letter of credit.

The principle of letters of credit, based on a neutral paymaster, has been around for thousands of years, yet is as modern as the most technologically advanced computer. Through text and diagrams, this handbook explains concepts that have frightened away prospective users.

It will form a welcome addition to the library of all engaged in international trade!

Preface

This is a handbook to introduce documentary credits (also known as “letters of credit”) to sellers and buyers (commercial parties) who seek to increase their access to cross-border markets. Above all, it is an introduction. It does not make readers experts on documentary credit transactions. Rather, it strives to demonstrate the way commercial parties and bankers have used this remarkable commercial device, the documentary credit, to achieve their objectives.

As this handbook demonstrates again and again, documentary credit transactions are document driven. An essential part of this remarkable story are the efforts of the International Chamber of Commerce (ICC) and its Commission on Banking Technique and Practice (the “Banking Commission”) to develop practical rules for those documents. These practical rules are the Uniform Customs and Practice for Documentary Credits (UCP). The current version of those rules, implemented on July 1, 2007, is UCP 600. UCP 600 appears as an appendix to this handbook, which refers to UCP articles throughout.

The handbook is divided into five parts:

Part One provides a brief discussion of international sales and transport.

Part Two explains the banking industry’s crucial role in documentary credit transactions and illustrates many of the transactions in which commercial parties utilize the documentary credit.

Part Three explains the way documents control the payment function of the documentary credit. It is here that we discuss the strict compliance rule and the way this rule preserves the credit as an inexpensive banking product that can protect both sellers and buyers.

Part Four introduces the all-important feature of the documentary credit—the ways in which it opens financing options to sellers, who can then extend credit to buyers. Critical to cross-border sales, these financing features often save the commercial parties far more than the documentary credit costs and are an added benefit, supplementing those features of the credit that protect the seller’s payment expectations and the buyer’s performance expectations.

Finally, **Part Five** introduces the standby credit and illustrates its role in cross-border transactions. Documentary credits take two forms: those that are intended to be paid and those that are not. This handbook refers to the ones that are intended to serve as the means of payment for goods as “commercial letters of credit” and those that are only intended to be paid when a transaction has gone awry as “standby letters of credit” or just “standby credits” or “standbys”. While standbys are a relatively recent invention and work somewhat differently from commercial letters of credit, they are based on the same principles. All letters of credit are documentary, but commercial letters of credit typically call for documents evidencing shipment of goods, while standby letters of credit typically call for documents attesting to default on the applicant’s part in some agreement with the beneficiary.

Before embarking on the handbook's discussion of documentary credit transactions, it is important to understand the risks that cross-border sellers and buyers face and the ways in which the documentary credit reduces or eliminates those risks. When they enter into an international sales contract, sellers and buyers in different countries face a number of risks that they do not face in domestic sales.

Information

In today's world of internet marketing, cross-border sellers and buyers do not usually know one another well. They do not deal face to face. They might not know one another's reputation for product quality or creditworthiness. The seller will not know the reliability of the buyer's bankers, and neither party is intimately familiar with the commercial practices of its counterparty's country. Their deal, moreover, may be a one-shot transaction. By virtue of distance, language and commercial opportunity, they are often unlikely to establish a commercial relationship.

In a documentary credit transaction, the buyer's bank will know the buyer, be able to evaluate his creditworthiness with far more accuracy than the distant seller and decide whether to issue a documentary credit on the strength of that creditworthiness.

Communication

Even in the age of modern telecommunications, commercial parties cannot routinely avail themselves of closed communications systems that utilize data security capabilities that guard against fraud and forgery. They cannot know for certain the identity of the party with which they are communicating or whether the documents have been executed by the nominal party.

Through the Society for Worldwide Interbank Financial Telecommunication (SWIFT), the banking industry has developed an inexpensive, closed system for electronic data interchange that virtually eliminates the risk of fraud or forgery for establishing, amending and honouring letters of credit and for transmitting messages that effect the movement of funds from one bank to another.

Exchanging Currencies

Because they are located in countries that use different currencies, the seller and the buyer face the risk that exchange rates or currency control laws may have an adverse impact on their transaction. Sellers and buyers often do not engage in currency trades or hedging, and they may be taken by surprise when the buyer's country alters currency control regulations such that they prevent the buyer from paying for imports.

The imposition of exchange rate controls is considered a political risk (see next section), and protection can be obtained in the form of confirmation of the documentary credit by a bank outside the jurisdiction of the exchange control regulations. Similarly, from time to time, countries suffer foreign exchange shortages due to economic issues. Even though currency exchange is not prohibited by regulation, foreign currency may not be available. A letter of credit confirmed by a bank based and operating in another country is payable by the confirming bank regardless of such situations, though the seller must still check on and have confidence in the laws of the confirmer's country.

Although they can provide protection against exchange controls and foreign exchange shortages, documentary credits do not provide any protection against exchange rate movement. Protection against exchange rate movement can be added to documentary credits in the form of forward exchange contracts and currency exchange options. Because banks maintain deposits in foreign currencies for the purpose of engaging in international payment transactions, they can contract to sell one currency for another at a future date at a price that is agreed in advance. Such an agreement is called a forward contract. If the need to exchange currencies is not definite, or if the party with the need to exchange currencies wants protection against losses but wants to enjoy any gains, an option to exchange one currency for another can be used instead of a forward contract. Use of either of these vehicles will reduce the risk of currency exchange losses. The low cost of forward contracts and currency options from banks that are active in this business reflects their efficiency at exchanging currencies.

Political Risk

Sellers and buyers will almost never be able to control the risk that political upheaval or regulatory action may interfere with the seller's or buyer's performance of the sales contract. While political risk is not a major factor in many markets, sellers that avoid all politically volatile markets lose profit opportunities.

Banks worldwide maintain credit lines with large banks in international banking centres. Relying on those credit lines and on their familiarity with the laws of the various jurisdictions, the world's largest and most reliable banks can issue and confirm credits for smaller banks and thereby absorb the risk that political instability in a smaller bank's country will disrupt payment. The major banks employ sophisticated methods for monitoring, diversifying and hedging these risks as well as for recovering losses.

Credit

Even buyers with good credit reputations default from time to time. Because the commercial letter of credit transaction replaces the credit risk of the buyer with that of the bank issuer, the seller need not worry that its obligor will become insolvent. When the buyer's bank is not so strong or is located in a country with high political or economic risks, it is often possible to arrange for the letter of credit to be confirmed by a larger, stronger bank in a stable country.

Quality

Unscrupulous sellers may take advantage of distance and language barriers to ship goods or commodities of poor quality. Buyers may wish to condition payment on inspection of the goods, a service that is available from companies that specialize in conducting inspections all over the world.

The documentary credit allows the buyer to protect against the delivery of non-conforming merchandise by including a requirement that the seller must submit a specified inspector's certificate of quality, contract compliance or other critical issue of product compliance as one of the documents that must be presented to obtain payment.

Financing

Even a strong seller will usually not finance a buyer who wants time to sell the subject of the international sale and generate funds to pay the seller, and many sellers prefer not to finance the transaction even for the several days it takes to transport the goods to the buyer's place of business and for the buyer to arrange payment. These payment delays are major headaches for international traders.

Given the financial strength and reliability of banks obligated to honour a documentary credit, the seller's bank will often make an advance to the seller when it delivers documents to the bank for forwarding to the nominated bank or issuer for payment. If the buyer has negotiated additional time before paying, the seller may agree to ship against a documentary credit that calls for presentation of time drafts, i.e. drafts payable at a set time in the future. When the seller presents the specified documents, rather than paying immediately, the drawee bank (the bank on which the draft is drawn) is obligated to endorse the drafts with the word "accepted". After the confirming bank, the nominated bank or the issuing bank has accepted the seller's draft or otherwise signalled its agreement to make a future payment, the bank has created a marketable asset for the seller. A bank's obligation to pay at a future date is generally more acceptable than the future payment obligation of a buyer unknown to money market investors.

Reducing Risks and Costs

Five features of the documentary letter industry reduce these risks and keep costs low.

First, documents that bankers can examine drive the transaction. Under the documentary credit, banks decide whether to honour or dishonour on the basis of documents. Banks do not need to open containers to examine shipments, and they do not hire lawyers to interpret international sales contracts. The documentary credit is independent of related contracts and transactions. Banks deal only in documents, not goods. This feature of the documentary credit saves bankers time and money and allows them to keep the cost of the commercial letter of credit relatively low, yet it also permits sellers and buyers to protect themselves.

Second, the documentary credit substitutes the financial strength of known and reliable banks for that of small banks and commercial buyers.

Third, the SWIFT communications system largely eliminates the risk that a party will forge a documentary credit, an amendment to the credit or a payment order.

Fourth, international department bankers and documentary credit experts staff the International Chamber of Commerce Commission on Banking Technique and Practice, the Commission that supervises the drafting of the Uniform Customs and Practice for Documentary Credits (UCP). Most commercial letters of credit incorporate the UCP, which lays down rules for letters of credit that facilitate uniform bank treatment of documents throughout the trading world. The current version of the UCP (UCP 600), implemented on July 1, 2007, goes a long way towards making documentary credit transactions stable and predictable.

Fifth, documents under documentary credits that incorporate the UCP must satisfy international standard banking practices. The ICC Banking Commission has published a handbook, *International Standard Banking Practice for the Examination of Documents under Documentary Credits* (ISBP, 2007 Revision for UCP 600), on those practices to aid document examiners at banks and to achieve uniformity in document examination. From time to time, the Commission also issues opinions and interpretations to clarify documentary credit practices. These opinions often appear in *DCInsight*, an ICC quarterly newsletter, and are compiled in books available from ICC Services. ICC also provides a dispute resolution service, DOCDEX, whereby a panel of three experts decides each case. The ICC International Centre for Expertise hand-picks each expert after careful screening to check his or her qualifications and independence. Experts include bankers, lawyers, consultants and individuals who have dealt with letter of credit issues for many years. The Centre can call upon experts from over 70 countries, who review the evidence and base their decision on the relevant ICC rules. These DOCDEX decisions often appear in *DCInsight*.

The purpose of this handbook, then, is only to introduce the reader to the documentary credit, to the ways in which buyers can cause the documentary credit to be opened, to the ways in which commercial parties and bankers use it and to the transactions it serves. This handbook will not make the reader an expert on letters of credit, but it will permit sellers and buyers to understand the documentary credit and avail themselves of the advice of their bankers, forwarders and consultants. In short, it should permit those unfamiliar with the documentary credit to use it to reduce their risks and save money.