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Title:

UCP 600: Letter of Credit Rules Revised

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Abstract

Letters of credit remain an important tool for financing and settling international trade transactions. They enjoy wide acceptance in the trading community because they are considered to carry low financial risk.

Letters of credit are subject to specific rules that were first codified by the International Chamber of Commerce (ICC) in 1929 and since updated on a regular basis. In October 2006, the ICC announced that a new revision of these rules, the ICC Uniform Customs and Practice for Documentary Credits 2007 Revision (UCP 600), would become effective from 1 July 2007.

In this paper, a contextual background to the contracts and mechanisms emanating from letter of credit transactions is firstly provided, followed by discussion of both select major changes to the existing rules and the challenges associated with their implementation. Comments on other associated rules that may impact on the UCP 600 are also incorporated in the discussion. The paper concludes that the ICC's revision of the UCP 600 has, in some respects, resulted in improvements over current rules, however these may not produce the desired effects, because of the imprecise definition of international standard banking practices leading, in particular, to payment uncertainty for exporters.

Introduction

Letters of credit have been described in English courts as the “the life blood of international commerce” (D'Arcy, Murray & Cleave 2000, p. 166) and generally speaking judges have been reluctant to interfere with established mercantile practices related to such transactions. The importance of letters of credit in trade finance transactions is evidenced by its global acceptance, with an estimated usage in excess of USD 1 trillion per annum (Klein 2006, p. 1).

“A letter of credit is a complex, practical instrument whose governing principles have developed over time as a result of customary banking practice”(Kingman-Brundage & Schulz 1986, p. 66). The various contracts and parties involved in the transaction, and the pedantic nature of documentary compliance demanded by the banks, are what makes this method of payment complex. The cost of operating with a letter of credit is comparatively higher than other methods of payment. Typically banks charge an establishment fee based on a percentage of the total value of the letter of credit (that varies from bank to bank and country to country), and this fee is payable by the applicant (importer). The exporter (beneficiary) carries the burden of documentary compliance and this comes at a cost, due to the high failure rates experienced globally by exporters in failing to meet bankers' requirements for documentary compliance¹. The International Chamber of Commerce (ICC) estimates that there is up to a 70% documentary discrepancy rate in letter of credit transactions (ICC Thailand 2002) and that in the UK alone, this has been estimated to cost business £113 million per annum (SITPRO Ltd. 2003, p. 2). The cost and complexity of letter of credit transactions therefore make them ideally suited to transactions that are comparatively high-risk and high-value, and this is likely to mean that the potential financial losses may be significant. The issue of documentary compliance will be considered later in this paper.

¹ The words seller, exporter and beneficiary are used interchangeably in this paper, as are the words, buyer, importer and applicant.

The modern development of letter of credit contracts and banking practice

The history of the codification of the modern letter of credit is a testament to the developments that have taken place in the past seventy-eight years. The first attempt to codify letter of credit practice can be traced back to 1929 when the ICC, following an earlier American initiative, introduced its 'Uniform Regulations for Commercial Documentary Credits' (Wheble 1971, p. 97). Unfortunately these regulations were only limited to Belgian and French banking practices, and whilst these failed to gain wide acceptance, they nevertheless provided a basis for further developments.

In 1933 the ICC issued the 'Uniform Customs and Practice for Commercial Documentary Credits' and this set of rules "received formal acceptance in some 40 countries" (Wheble 1971, p. 98). Although the 1951 Revision doubled the acceptance of these rules, it was not until the issue of the Uniform Customs and Practice for Documentary Credits in 1962 that global acceptance took place. Since then the rules have been regularly updated in 1974, 1983 (UCP 400) and 1993 (UCP 500) to arrive at the current 2007 Revision, commonly referred to as the UCP 600². It is beyond the scope of this paper to undertake an analysis of the historical changes to the words and their meanings across the seven revisions since the original issue of the rules.

The research question posed in this paper is: Will the UCP 600 reduce the documentary discrepancy problem? Discussion will be limited to three areas of change between the existing set of rules at the time of writing – the UCP 500 – and the new rules to take effect from 1 July 2007 – the UCP 600. These three areas of change are:

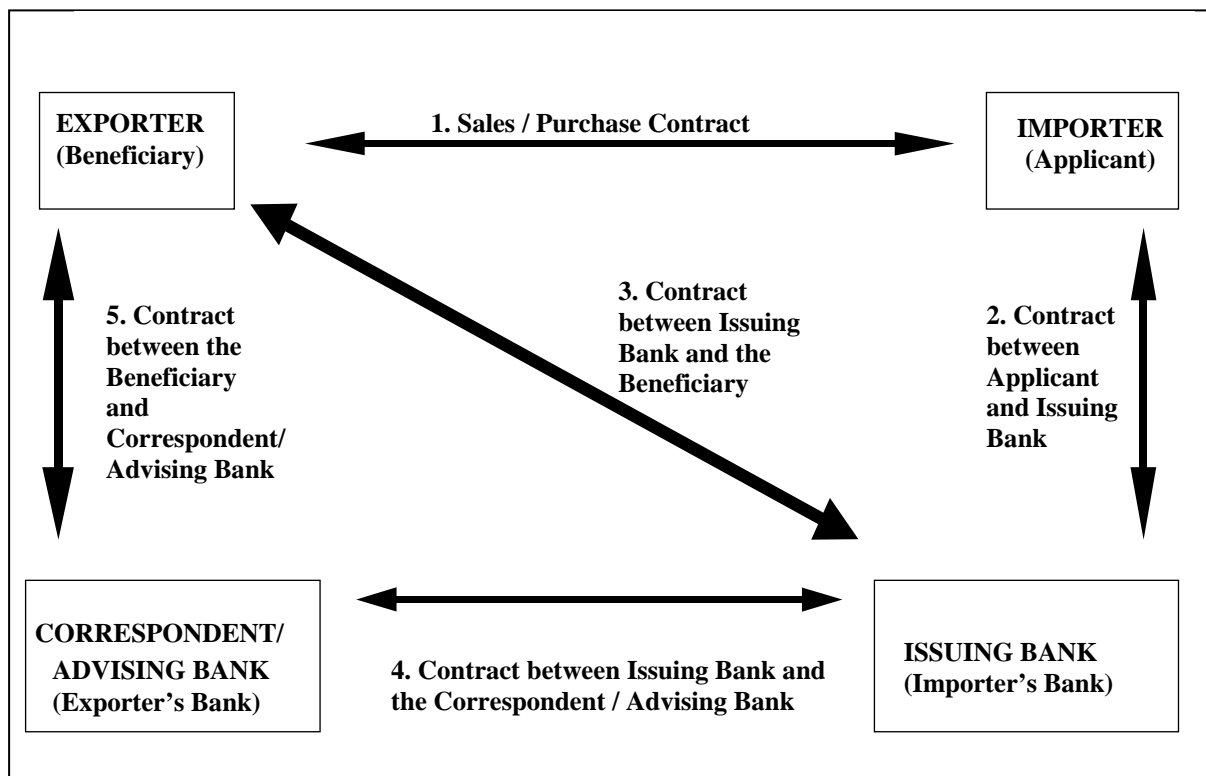
- a) the description of the goods on the commercial invoice;

² From the 1984 revision the trading and banking communities began to refer to the Uniform Customs and Practice for Documentary Credits by its acronym of UCP and adding to it the ICC publication number (the official text of the rules), to indicate the revision in use. Therefore the 1983 revision became the UCP 400, the 1993 revision became UCP 500 and the 2007 revision became UCP 600.

- b) transport documents issue and validity; and
- c) the standards for examinations of documents.

It is important to note that the UCP is not law. It is a set of private rules that contracting parties choose to incorporate into the relevant contracts. The UCP can only apply to a letter of credit transaction by express inclusion and such inclusion must incorporate the applicable revision, e.g. UCP 500. The mechanism by which the letter of credit works is quite complex and gives rise to a number of contracts emanating from, but separate to, the contract of sale, as shown in Figure 1.

Figure 1: Typical contracts arising from a letter of credit transaction (Bergami, Roberto 2004, p. 261)



Contract number one is the sales/purchase contract that the exporter and importer negotiate, choosing the letter of credit as the method of payment. The importer needs to apply to his bank to have the letter of credit issued, as per contract number two. Because this bank is providing an undertaking to pay the exporter, it typically seeks some prior form of security from the applicant – this may be a mortgage on property, or the equivalent amount in cash, or

any other arrangement the bank deems suitable. The security need not be for the full value of the letter of credit, and this is at the discretion of the bank.

Contract number three represents the undertaking to pay, given by the issuing bank to the exporter; however this undertaking is conditional. The beneficiary must comply fully with the requirements of the letter of credit for the payment to be effected. Compliance is subject to the satisfaction of the bank involved and it is based on documentary data alone, and not against the goods. In other words the bank having received the documents, checks them for compliance and pays, or not, accordingly.

Contract number four represents the engagement of the overseas bank in the exporting country (usually the exporter's bank) by the issuing bank – this engagement being on a correspondent basis. The reasons for this contract are mainly due to authentication of the credit and business facilitation. It would be possible for the exporter to receive the credit directly from the issuing bank, but considering that international trade is not immune to fraud, questions about its authenticity may arise, therefore the exporter's bank plays a role in verifying the bona fide of the letter of credit. The exporter's bank also provides a facilitating role in letter of credit transactions, for in its absence, the exporter would need to deal directly with the issuing bank, making the task of on-time lodgement of documents more expensive and difficult and less certain, as international couriers would need to be used and the document delivery tracked by the exporter.

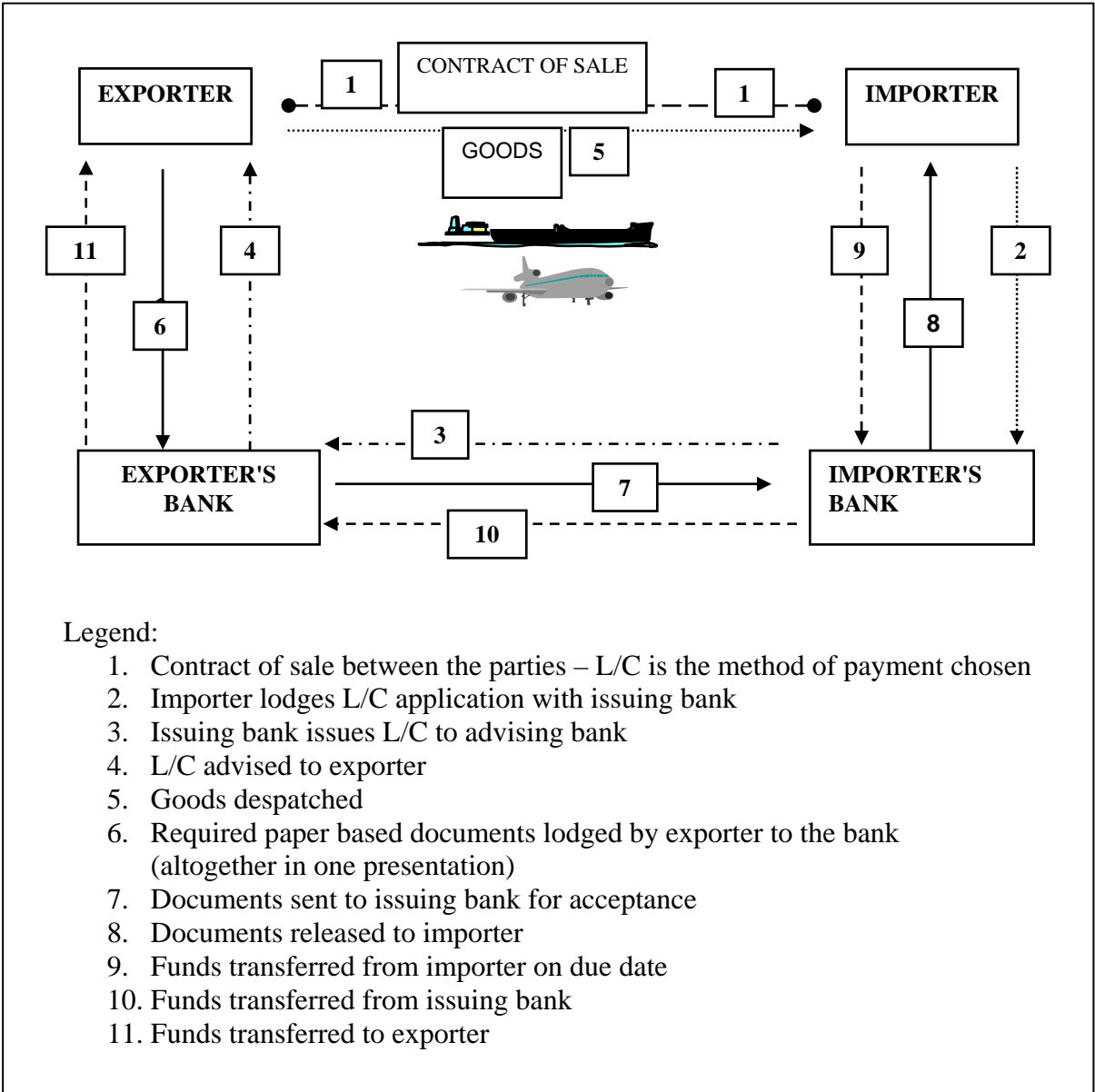
Contract number five is a service contract between the exporter's bank and the exporter. The exporter bank may perform different functions, depending on its acceptance of the instructions given in the letter of credit by the issuing bank. For example the exporter's bank may, in the case of a letter of credit drawn at sight, be able to pay the exporter immediately on lodgement of compliant documents and claim reimbursement from the issuing bank. These

banking arrangements are not normally cause for concern by the exporter, as long as the letter of credit instructions set up appropriate mechanisms to pay as due.

The mechanics of the letter of credit transaction

The mechanics of the letter of credit transaction can be quite complex, as shown in Figure 2. As mentioned earlier, the question of documentary compliance is critical to the exporter to secure payment from the issuing bank. Steps four and six in Figure 2 are critical to maximising the exporter’s chances of presenting compliant documents.

Figure 2: Typical letter credit cycle - deferred payment option (Bergami, Roberto 2006, p. 442)



Step four signifies the receipt of the letter of credit by the exporter. It is at this stage that the exporter needs to carefully scrutinise the letter of credit to ensure that it complies with the terms and conditions of the contract of sale agreed to, prior to the issue of the letter of credit. Any deviations should be corrected by seeking necessary amendment(s) to the letter of credit from the buyer, through the issuing bank, prior to the exporter making arrangements for the movement of the goods in question. The exporter should also satisfy himself that

- the terms and conditions of the letter of credit in terms of performance can be met (e.g. shipping on time, presenting the documents within the allowable period, etc.); and
- the requirements for data contents on documents to enable compliance with the letter of credit can likewise be met (e.g. certification by official bodies with particular wording requirements, third party issued transport and insurance documents).

The exporter should only proceed with the supply of the goods after he is satisfied that the letter of credit requirements can be met – to do otherwise would jeopardise the security of the payment afforded by the letter of credit.

Step six is probably the most crucial point of the letter of credit cycle. The exporter presents all the required documents to his bank. If the documents comply, payment will take place at the appropriate time period specified on the letter of credit. Compliance must be to the satisfaction of the bank, and this has been the subject of some tension between exporters and issuing banks, particularly in Asia. It is known that the practice of “manufacturing discrepancies” is commonly adopted in this area of the world, as a ploy to generate extra income on rechecking documents, and this fact was readily admitted by banks at an ICC meeting in 2005 (Kreitman 2005, p. 2). The manufacturing of discrepancies usually occurs where the issuing bank has taken less than 100% security, and the buyer has insufficient funds to meet the payment under the letter of credit. It is therefore usually a payment delay scheme, rather than an outright refusal against the debt. The bank is able to ‘buy time’ by citing

discrepancies that are easily overcome through technical argument, but whilst the debate continues, no funds change hands. Although this practice has certainly been condemned in the past, evidence proves that it is still ongoing today. It is difficult to see how any set of rules would overcome this situation, but the ICC have sought to do so with the UCP 600. There have been a number of changes to the UCP 500 that are touted to produce improvements in documentary compliance rates for exporters. The major changes are discussed below.

The UCP 600 ‘improvements’

The UCP 600 is not expected to produce much change to current practices. There have been minor adjustments that are beneficial to exporters, such as shortened time frames for banks to check documentary compliance. Originally a maximum of seven clear bank working days under article 13(b) of the UCP 500, are now reduced to five clear bank working days under article 14(b) of the UCP 600. There are some potential cash flow advantages particularly when payment is at sight, or at a maturity date linked to the sight of the documents. The definitions in article 2 of the UCP 600 provide clarification on some matters, however, there are still a number of major issues that remain unresolved to date.

Amongst the biggest concerns of the UCP 500 have been the articles that focus on

- a) The description of goods on the commercial invoice;
- b) Transport documents; and
- c) The standards for examination for documents.

The above points represent the majority of effort spent by the ICC in the past twelve years in clarifying interpretations of the UCP 500 through the issue of position papers and opinions (Collyer 2006; Department of Policy and Business Practices 2003, p. 2), and it is in this context that the relevant UCP 600 articles are considered.

a) The description of goods on the commercial invoice

The problem with the description of the goods on the commercial invoice is the level of accuracy demanded by the letter of credit rules, and this commonly leads to discrepancies even for the most minute deviations from the letter of credit stipulations.

A crucial matter for the issuing bank is to ensure that the correct goods are supplied, but this can only be done by checking the documentation presented by the exporter.

Indeed, there is a well established principle in banking practices related to letter of credit transactions that is commonly referred to as the 'independence principle'. This is the separation of the letter of credit from the contract of sale, as per article 4 of the UCP 500 and UCP 600 (International Chamber of Commerce 1993, p. 4, 2006, p. 19).

It is both a desirable and logical separation because of at least two reasons:

1. Banks are not a party to the contract of sale and therefore would not be privy to its contents, nor should they be concerned with, or be bound by it. The role of the banker is to finance trade, not become a merchant in it.
2. Trade facilitation. If banks were responsible for checking supply compliance against the sales contract, the system would grind to a halt. Instead of banks being able to relatively quickly dispense with the task of checking documentary compliance, they would have to undertake comprehensive and extensive checks of matters such as the conformity to the contract of the goods supplied and their logistical movement. Apart from the fact that banks may not be equipped with the necessary skills, because this is not their core business area, if the requirements for these checks were imposed upon them, the recouping of associated banking fees would render the letter of credit prohibitive to use on a cost basis alone.

It is generally accepted that the commercial invoice is the most vital document in any business transaction, and its importance is increased in international trade transaction because of the number of parties who rely on this document in the discharge of their duties. These organisations include the customs and other barrier control authorities, the logistics industry moving the product, the insurance company providing protection for damages/losses in transit and, of course, the banking industry being involved in trade facilitation and finance. Perhaps the importance of the invoice is what led to this document attracting such attention in the UCP. The UCP 500 article 37 is quite specific about aspects of the data content to be provided for the bank to check (International Chamber of Commerce 1993, p. 44):

The description of the goods in the commercial invoice must correspond to that of the credit.

This article led to the doctrine of strict compliance that banks apply during the documentary check function. The standard applied to this check is discussed below. Banks do not expect the description to be laid out exactly as shown on the letter of credit, but the data elements contained in the invoice must be a match to the letter of credit. In other words, the sequence or the order of the details is immaterial, but must comply. In bankers implementing the requirements of Article 37, there is no room for a 'doctrine of materiality', where 'close to', but not 'exact' may be accepted. The wording of Article 37 simply does not allow a flexible approach. It can therefore be imagined that when the bank, in accordance to the requirements of article 37, applies the doctrine of strict compliance, discrepancies may not be difficult to uncover, and this is what contributes to the 70% documentation error rate referred to earlier.

If the application of the doctrine of strict compliance was to be relaxed, then it may be argued that documentary compliance rates might increase. Given that every transaction is accompanied by an invoice, then this is an important consideration.

Unfortunately, for exporters in particular, the need for strict compliance has not been removed in the UCP 600, as evidenced by article 18(c) (International Chamber of Commerce 2006, p. 30):

The description of the goods, services or performance in a commercial invoice must correspond with that appearing in the credit.

It seems therefore that some of the established principles will not change with the new rules.

b) Transport documents

Traditional transport documents, such as the Bill of Lading, have been issued for many years by shipping lines, or their agents, and have been readily accepted by the banking community as meeting the requirements of Step 6, Figure 2.

The ICC clarified certain aspects relating to the issue and validity of various transport documents covered by articles 23 to 26, and 30, of UCP 500 through Position Paper No. 4 (Commission on Banking Technique and Practice 1994), focusing on:

- aspects of the data content of transport documents,
- who may issue such documents, and
- the acceptability of the signatory by virtue of their stated role (e.g. agent) or title (e.g. carrier).

Transport documents issued by freight forwarders have been acceptable by the UCP 500 under article 30, reflecting the common practice of exporters entrusting the freight forwarder with the movement of goods and the issue of a specific transport document that is equally acceptable by the importer receiving the goods. This document is the International Federation of Freight Forwarders Association (FIATA) transport document.

UCP 600 has removed this opportunity from future letter of credit transactions, as simply because the equivalent article in the transport documents section no longer appears. Not surprisingly, FIATA expressed grave concern with this situation, as early as 29 March 2006 (International Federation of Freight Forwarders Associations 2006), several months before the UCP 600 went to a vote for adoption in Paris. However, it would appear that FIATA's pleas were ignored. This situation may have significant impact because if the FIATA transport document cannot be used, then the freight forwarder cannot operate as a carrier, limiting the choice of transport documents available under letter of credit transactions, with consequential carriage contract and logistical implications.

c) **The standards for examination for documents**

The undertaking of a bank to pay under a letter of credit transaction relies on documentary compliance, therefore a beneficiary must possess a clear understanding of the expectations of bankers.

As documentary acceptance must, in the first instance, satisfy banking requirements, the standards applied in the documentary checking process are therefore paramount. This is arguably the area of most contention. The differences in opinions, as to whether documents comply or not, are based on a combination of different interpretations given by various parties to the text of the UCP and the agenda that may present, e.g. the 'manufacturing of discrepancies' outlined earlier in this paper.

Article 13 of the UCP 500 (International Chamber of Commerce 1993) provides a fertile ground for discrepancies as

Banks must examine all documents stipulated in the credit with reasonable care, to ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the credit. Compliance ... shall be determined by the international standard banking practice as reflected in these articles.

The article itself is quite specific about the use of the standards to be applied, the problem was that the UCP 500 were issued in 1993 and the standards referred to as being 'reflected in these articles' were not actually published by the ICC until 2003, that is 10 years after they were supposed to be in use. The standards issued by the ICC are the International Standard Banking Practice (ISBP) for the examination of documents under documentary credits. There is an interesting difference in the application of the UCP 500 to a letter of credit versus the usage of the ISBP when checking documents under a letter of credit transaction. Whereas the UCP 500 by virtue of article 1, 'are binding on all parties' (International Chamber of Commerce 1993, p. 10), meaning these rules must be followed, the ISBP carries no mandatory adoption by a banker checking documents under a letter of credit. Furthermore, the ISBP have no authority in their own right, as the ICC declared them to be "guidelines" in the interpretation of the UCP 500, because "the ISBP do not amend the UCP" (International Chamber of Commerce 2003, p. 3). The ICC's hope was that the ISBP would contribute to a 'significant reduction in the number of documents refused for discrepancies' (International Chamber of Commerce 2003, p. 4). It is argued that the inability to mandate the ISBP as a standard has been ineffectual and has instead injected an amount of uncertainty in the letter of credit documentary check process, by creating a "dual tier banking system" (Bergami, R. 2005, p. 12). This could eventuate in a letter of credit transaction when upon checking documents presented, one bank may decide to follow the ISBP (as guidelines) and declare documents compliant, whereas another may not consider the ISBP and declare the documents discrepant. Given that there is no obligation for a bank to declare its adoption of the ISBP or otherwise, there is no certainty in the outcome of the documentary process. The ISBP in any case enjoys no authoritative status of its own, as banks 'must state all

discrepancies in respect of which the bank refuses the documents”, based on UCP 500 article 14 d (iii) (International Chamber of Commerce 1993, p. 20).

In summary then, the documentary process is conducted seemingly in accordance with a ‘standard’ that upon closer examination, is neither authoritative in its own right, nor has mandatory application. This should be of concern to exporters, particularly as the UCP 600 offers no better options in article 16 (International Chamber of Commerce 2006, p. 28)

When a ...bank decides to refuse ... it must give a single notice to that effect to the presenter. The notice must state ... ii) each discrepancy in respect of which the bank refuses ...

The relevance of the ISBP is cast into even more doubt by the definitions provided by UCP 600 article 2 (International Chamber of Commerce 2006, p. 17), that state (in part)

Complying presentation

A presentation that is in accordance with the terms and conditions of the credit, the applicable provisions of these rules and international standard banking practice

There is nothing in article 2 above that in any way means that international standard banking practice is necessarily the ISBP alone (Kreitman 2006), or any publication for that matter. It would be possible for any bank to develop its own ‘standards’ and if that were the case, the result may well be a complete breakdown of any ‘equivalence’ of checking, and confusion would reign supreme. Nevertheless, the ICC has now decided to review the ISBP to bring it into line with the UCP 600. However it does not appear as though this revision will be available until later in 2007, after the effective date of the UCP 600. Once again there will be a gap, as the standards of practice will not be available until some time after the new rules have become effective. The new version of the ISBP will provide little comfort after it is released because it will, like its predecessor, be limited to having ‘guideline’ status only and

lack any real authority. It is difficult to understand how the ICC can envisage a situation where discrepancies will be lessened by invoking voluntary standards. Such a policy decision seems to run contrary to the notion of certainty of outcomes, yet for the letter of credit to remain relevant and important to today's business environment, traders must be able to operate with confidence in outcomes. Lack of definitive standards makes it virtually impossible to devise uniform staff training programs.

Conclusion

The questions of international standard banking practice and the lack of authority given to the ISBP by the ICC policy makers seems to contradict the very notion of standards. With options that include any organisation devising its own practices and referring to these as standards, the certainty of the documentary check outcomes is very unclear indeed. This could have catastrophic consequences if the notion of 'manufacturing discrepancies', outlined earlier, is considered in this context.

The elimination of the FIATA transport document will no doubt have significant impact on international contracts of carriage arrangements, and therefore international logistics arrangements.

Despite the knowledge that documentary discrepancies are at internationally high levels in letter of credit transactions, the ICC has retained the doctrine of strict compliance, particularly for commercial invoice data, rather than adopt a different policy initiative that might have resulted in a doctrine of materiality, thereby eliminating trivial non-compliance issues. The costs associated with the continual non-compliance are considerable, and industry will ultimately have to bear the costs.

Finally, staff training within the international banking industry and within the trading community is likely to be a major hurdle. This is likely to exacerbate problems of

interpretation and compliance, and continue to add to the plight of the exporter in attempting to achieve payment under a letter of credit transaction.

There is scope for possible future research in reviewing the UCP600 Articles 4, 16 and 18(c) in the light banking practices that will evolve with use of the new rules. Exporters and importers, as well as service providers (such as carriers, forwarders and customs brokers), could be surveyed to ascertain the impact of the UCP600 on documentary compliance requirements and causative discrepancy rates. This information could provide the basis for informing and influencing future banking practices.

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