

# ARTICLES



## THE CASE FOR INTERNATIONAL STANDARD BANKING PRACTICES FOR THE EXAMINATION OF DOCUMENTS (ISBP)

by Donald Smith\*

Use of Letters of Credit can be traced as far back as the 15<sup>th</sup> Century BC when Phoenician traders carried them to foreign ports in the form of clay tablets. Their ongoing viability over so many centuries is compelling testimony to the simplicity of their basic premise and the integrity of their intention — to substitute the lender's credit worthiness for that of the buyer — in order to pay for a shipment of goods or services from one party to another. Today, it is estimated that 15% of world trade, with an approximate value of US\$ 1.023 trillion, is transacted through the use of these instruments.

Letters of Credit play an important role in the growth and profitability of international trade and are a key component in its expansion. But understanding these time-proven instruments requires knowledge, patience, and an adherence to detail that is often missing in an expanding environment — and unless resolved, could become

an obstacle to future growth and profitability.

The first hurdle appears when the Applicant (the Buyer) completes the application form, asking the bank for a Letter of Credit (LC), affirming its obligation to reimburse the bank for payments it makes to the Beneficiary (Seller). At this point, it is clear that by issuing an LC for the Applicant, the bank is providing a specialized form of undertaking to the Beneficiary — the right to receive payment on the timely presentation of documents that on their face comply with the terms of the LC. However, what is not so clear is that this right is not contingent upon the beneficiary's actual compliance with the underlying contract of sale, *but rather upon the beneficiary's presentation of complying documents.*

How does the bank which examines the Beneficiary's documents determine if they comply with the terms and conditions of the LC? The

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decision is based on the bank's understanding of the "Uniform Customs and Practice for Documentary Credits" (UCP), a document first published by the International Chamber of Commerce in 1933, and incorporated by reference into almost every commercial letter of credit issued globally. Although the most recent revision was in 1993 (known as UCP 500), a substantial amount of the original structure and language remains unchanged after almost 70 years. While more knowledgeable practitioners may understand the language, it is open to confusion and misinterpretation among the rapidly growing ranks of those less experienced. Lack of understanding of these rules leads to an unfortunate situation and documents which do not comply with the Letter of Credit requirements.

Sub-Article 13 (a) of UCP 500 states: "Compliance of the stipulated documents on their face with the terms and conditions of the Credit shall be determined by international standard banking practice as reflected in these Articles." Lack of understanding about how the standard banking practice is actually applied has led to an astounding situation:

*over 2/3 of the time the Beneficiary's documents fail to meet the LC Terms and Conditions upon their first presentation to the bank.*<sup>1</sup> The resulting delays in payment and on occasion, even non-payment, are not only time-consuming and bad for business, but also cast a shadow on all users of the Letter of Credit. Thankfully, all but an extremely small percentage of these problems are eventually resolved through Buyer/Seller/Bank communication. In fact, less than 1/10<sup>th</sup> of 1% of discrepant documents appear to result in less than full payment to the Beneficiary (Seller),<sup>2</sup> but the delay resulting from discrepant documents has potential ramifications on the Applicant (whose goods may be delayed), the Beneficiary (whose payment may be delayed), and the banks (who must re-examine documents). Even worse, unresolved discrepancies may result in expensive litigation.

In summary, the current LC situation can be a lose/lose/lose scenario for the Applicant, the Beneficiary, and the banks.

### **The Solution**

Practitioners follow several paths to gain an understanding of the correct application of the UCP: discussions with

peers and others who are more experienced in the business, professional associations such as the International Financial Services Association in the United States, or the Banking Committee of the United States Council for International Business (the "USCIB"). Unresolved questions may be referred to the Technical Adviser of the ICC Banking Commission who will answer with either a technical interpretation or educational response. As a rule, technical questions result in an ICC Opinion and information requests result in less formal educational responses. Since 1993, the ICC Banking Commission has approved more than 300 ICC Opinions and issued almost 900 educational responses. Not surprisingly, the majority of technical questions arose shortly after publication of UCP 500 and the number has declined steadily each year thereafter. However, educational questions have reversed that pattern, generating more than 600 responses since 2000.

To this author, the reasons seem obvious. The majority of technical questions relate to only a few articles and, once answered, begin to take the

1. "Discrepancies in Presentations against Commercial Letters of Credit", Ronald J. Mann, *Documentary Credit World*, November/December 2000, page 23.

2. *Ibid.* p. 30.

form of “Frequently Asked Questions” as the body of knowledge builds among users. Conversely, the increase in educational questions reflects the rapidly declining experience level of practitioners now employed

of the SBPED is frequently credited with helping to significantly reduce letter of credit litigation between parties in Mexico and the United States. Its adoption has been so widespread that the Task Force discussed

Pamphili in Rome. The following excerpt demonstrates the remarkable scope of the document:

***“... the current LC situation can be a lose/lose/lose scenario for the Applicant, the Beneficiary, and the banks.”***

by the market, such as Importers, Exporters, Banks, Insurance Companies, and Carriers. In addition, carryover of language from the original 1933 text may compound the problem and add an aura of mystery to the LC – creating opportunities for confusion and the occasional outright abuse.

While it is rare for disputed discrepancies to result in litigation, unfortunately it does occur. In 1997 the International Financial Services Association (then known as the US Council on International Banking) published a similar document, Standard Banking Practices for the Examination of Documents (SBPED). This publication reflects the significant undertaking of the US Council on International Banking and the Mexican Bankers Association to identify and document standard banking practices. The widespread use

below used it as the starting point for the ISBP.

The sheer number of inquiries prompted the ICC Banking Commission to form a 13- member Task Force co-chaired by Ole Malmquist (Denmark) and this author, Donald Smith (US). Other members of the Task Force include: James Byrne (US), Gary Collyer (UK), Haluk Eredmol (Turkey), Merike Gramer (Sweden), Wolfgang Heiter (Germany), Heinz Hertl (Austria), Reinhard Längerich (Denmark), Jean-Pierre Mattout (France), Neville Sawyer (UK), Shan Jianbao (China) and Soh Chee Seng (Singapore). Together, they have written a new document titled “International Standard Banking Practice for the Examination of Documents under Documentary Credits” (ISBP), which will be voted upon on 30 October 2002 at the Banking Commission meeting of the ICC at the Hotel Villa

“No exercise can anticipate all the terms or the documents that may be used in connection with documentary credits (“credits”) or their interpretation under the UCP and the standard practice it reflects, much less the evolution of practice in response to changing commercial needs.

Nevertheless, a serious attempt has been made to address discrete issues that commonly arise but are not expressly treated in the UCP in light of the principles that shape standard banking practice. The application of the UCP, and the practices documented in this publication, should enable parties to deal successfully with almost any examination eventuality.”

The IBSP deals with these practices, with specific explanations for items such as: Issuers of Documents, Language, Dating of Documents, phrases used to signify time on either side of a date of event, and acceptable formats. In addition, it deals with issues such as multiple pages and attachments to riders, originals, and copies, expressions not defined by the

UCP, misspellings and/or typing errors, abbreviations, shipping marks, signatures, certificates, and declarations, corrections and alterations and even documents to which Transport Articles do not apply.

The Task Force recognized some national practices may be both practical and wise, however they are not uniform internationally and therefore inappropriate in the ISBP. These may be dealt with in a future revision of the UCP.

The ISBP also offers a caveat in the introduction, stating, “Applicants ... should not assume that they may rely on these provisions in order to excuse their obligations to reimburse the issuer, since

their obligations, rights, and remedies depend upon their undertaking with the issuer, the performance of the underlying transaction, and the timeliness of any objection under applicable law and practice.” The ISBP deals with the application of the practices articulated in the UCP, and not with concerns not expressed therein.

In summary, the task force took great care to ensure that this document is consistent with the provisions of the UCP and with the Opinions, Decisions, and Position Papers of the Banking Commission as well as applicable DOCDEX decisions. Thousands of hours went into the drafting and four revisions – and justly so.

In the current environment, the need for greater transparency in letter of credit practices has reached critical proportions. When the ICC Banking Commission meets in October, the issue before them will be whether to vote the ISBP into existence as an official publication of the ICC Banking Commission, or to simply add it to the body of knowledge as an Educational Guideline. Adopting it as an official publication will be an opportunity to clear away the mystique that has risen around the Letter of Credit process – and to further polish the credentials of the International Chamber of Commerce as the world’s ethical and pragmatic rule-making body. ■