



LETTERS OF CREDIT CHALLENGES & FINANCIAL LOSS FACED BY EXPORTERS IN THE FORM OF DOCUMENTARY DISCREPANCIES

Apeksha Garg

Research Scholar Gitam University, Hyderabad

Abstract— There is no doubt about the risky nature of international trade. Such risk can be conceptualized as country risk, transportation risk, customer risk, etc. Documentary Letters of Credit (LC) have been used as a payment method in international business for many centuries to reduce the risk of the trade, primarily when parties are located in different countries and do not have precise information about the financial standing of each other. In such occasions, LC will reduce the risk of a trade by shifting payment obligation from the buyer to the bank as a legal entity in return for the presentation of complying documents with terms of credit by the seller. Familiarity with the legal nature and different legal frameworks which govern the international operation of documentary letters of credit can facilitate the process of international trade for business people and boost national economies. However, a lack of knowledge about them can impose huge losses on international traders. The situation will be more complicated when we understand that many internationally recognized legal frameworks can affect the operation of LC. They are frequently updated to address technological and economic developments in the global market. In this paper, the author tries to address issues associated with documentary LC.

Index Terms— Documentary letters of credit, fraud, international trade, risk management, LC discrepancies, Beneficiary, Applicant.

1 Introduction

In business reality, buyers always want to pay after they have received goods and inspected them properly. On the other hand, sellers wish to get paid even before the shipment of goods. Taking this conflict of interest into consideration, an LC transaction comes into existence which is considered a safety where the buyer has the guarantee of delivery of goods in good condition or as promised and the seller also feels relieved that payment will come once the goods reach the destination. To a businessman, it is the best way to do business if they are doing transactions based on an irrevocable letter of credit. But in such cases, sometimes business people need to be made aware of obligations & uncertain behavior of documentary letters of credit in the form of discrepancies introduced by the issuing bank. A letter of credit is a bank guarantee of payment. Bank assures that if the beneficiary completes the order as promised or as per the condition mentioned in

LC, in such case, their price will not get stuck & will indeed be paid. It is a way of reducing the payment uncertainty associated with the movement of goods.

An LC contract is a transactional instrument wherein a customer requests the bank to issue or confirm a letter of credit for a trade transaction. The bank thus undertakes to pay the seller/beneficiary even if the buyer fails to pay.

We know that documentary letters of credit (LC) are meant to ease and facilitate the transaction process of international trade. Still, their specific characteristics can increase the risk of mistakes and documentary discrepancies while being used as the payment method in the international transaction process. Many factors like exclusive use of documents, geographical distance, no sound prosecution & trials, Lack of knowledge at the beneficiary end, the diversity of the legal system at the international level, exporters' reluctance to take any legal process because of time and efforts required can be considered as reasons for LC fraud and more discrepancies issue in LC transaction. Annually, billions of dollars are lost due to document discrepancies & fraud in the course of LC transactions, such risk and uncertainty involved resulting in reducing the global acceptance of documentary letters of credit as the primary method of payment used in international trade. Most of us are unaware about fraud risk management & documentary discrepancy management because this area is still unexplored and underrated in international business. Many modules & rules have existed for buyer safety, but only some are available from the exporter point of view. Existing research is trying to fill the gap in the study on methods for mitigating fraud risk in operations with documentary letters of credit by using risk management theory in order to answer the question of how to manage fraud risk & documentary discrepancies in LC transactions. In a quest to answer the research question, the paper is divided into two parts: the first is dedicated to preventive measures. At the same time, the letter explores responsive measures of an enterprise to manage discrepancies in documentation during LC transactions.

As we all know, Foreign trade is a risky process that requires awareness of exporters to take the best possible payment measures before shipping their goods to the importer's destination. For international transactions, four common payment methods are used all around the globe, named as Advance payment, Open Account (OA), Documentary Collection, and Documentary Letter of Credit. All business people want to expand this business and discover new markets. That market could be national or international. Such business activities are challenging, and traders might incur huge losses due to different problems in the process of practicing financial transactions in business. Documentary Letters of Credit are used in international trade as payment methods in order to reduce commercial risks incurred in business which exporters and importers sometimes face during trade with an unknown and known partner.

Literature Review

As we know the LC transaction process is complex and interactions between banks and traders are there in LC transactions, there is a high probability for occurrence of documentary discrepancy. Risk of financial loss will rise when there is no possibility to sort out discrepancies. Such discrepancy can be considered as a significant risk to business and monetary loss for exporters as, according to ICC global rate of documentation discrepancy in LC process is about 60 to 70 % (ICC Thailand, 2002) LC discrepancy ratio in the USA is nearly 73 % while in UK it has been around 50-60 % (Mann, 2000; SITPRO Ltd, 2003); We all know the fact that costs of documentary discrepancy in LC has not been studied globally, but SITPRO study showed "that in 2000 the UK faced loss of £ 113 million because of documentary discrepancies under Letters of Credit" (SITPRO Ltd, 2003). The majority of discrepancies in practice of Documentary Letters of Credit include inconsistent data, late submission of bill of lading or absence of signature in bill of lading, mistakes in transportation document like exporter do transshipment & in LC its was mentioned transshipment not allowed, mistakes in draft, like drafts without signature and non matching invoice with credit amount,

inadequate insurance policy or insurance document is dated after sailing of shipment, and documents without signature (UCP 600, Articles 14(d), 19, 18(c), 28).

Many researcher like Baker, H.Alavi, Y Zang, Jimenez, Mehta, as well as Wickermerante and Rowe are those scholars who studies major areas of LC discrepancy in international LC documentation operation .In addition to cases which have been already mentioned about probable areas of LC discrepancy, researchers, provide more details on the this subject as:

Missing the last date for shipment and documents presentation, misinterpreting document presentation date as shipping date or vice versa because only one date is mentioned in draft, incomplete document of shipment, absence of insurance or inspection certificate , conflicts in presented of documents, incomplete information on commercial invoice, wrong currency in insurance document, issuing the insurance policy after Goods shipped, presenting documents which is not legal, presenting documents without signature.

Also Mann after studying five hundred Letters of Credit provides the most detailed inquiry into the LC discrepancies.

Table 1. Sources and types of documentary discrepancy in Letter of Credits (Mann, RJ, 2000)

Type of discrepancies	Occurrence	Percentage
Defective Document	293	85%
Missing Document	75	22%
Late Shipment	62	18%
Late Presentation	48	14%
Expired LC	36	11%
Overdraft	16	5%

Incorrect Shipment	14	4%
Partial Shipment	7	2%

We know that there are many credit risk evaluation methods developed for banks in order to help them in the valuation of their different products, But there is no such model that has been developed from the point of view of exporters. (Pridotkienė et al., 2006). All models are dedicated to fulfill requirements of banks, but these models are not designed after keeping exporters in mind. It is necessary to find out major types of documentary discrepancy and their areas in LC operation in which the exporter might face such risk and how they find their solution. After receiving the letter of credit, a beneficiary should check all the details of LC clauses with proper care. Also, the beneficiary can appoint one LC expert and needs to allocate enough time to apply for necessary amendments which prevent difficulties in the preparation of mentioned documents. In checking the LC clauses, two main issues should be considered by the beneficiary. First, the validity of the letter of credit should be confirmed. Validity check of an LC includes terms for payment, credibility of the issuing bank and if there is any requirement of confirming bank or not. (Hu, 2007). In case of any condition which can not be fulfilled by the beneficiary, the beneficiary should inform the applicant immediately and complete the amendment process. Also, the beneficiary should look at the deadline for shipment; amendments should be clarified by the seller, as well as any new required guarantee and extension of LC's expiry date due to delays caused by the required amendment (Cheng, 2007). The beneficiary can claim damages if the applicant refuses to make amendments or extends LC's expiration date.

(Y.Zhang,2011) In addition, the Lack of an efficient prosecution system is a significant reason for L/C fraud.⁴⁷ Despite the huge loss resulting from L/C fraudulent activity in international trade, no international agreements have been reached to facilitate the detection and prosecution of such fraudsters. Neither banks nor buyers can find the fraudsters, even in cases where the fraudsters are detected; it seems impossible to do anything, such as bring legal action in a faraway and strange country. In addition, victims are usually not willing to make great efforts to respond to L/C fraud as the costs involved can be larger than the loss. Also, it takes a lot of effort, and exporters don't want to go through that much pain and he just withdraws himself. We can't deny that international traders have used letters of credit (LCs) as a basic form of international commerce. But because of certain uncertainty and challenges in LC transactions, many traders are planning to shift their status to open accounts to mitigate the risk involved in LC transactions. According to some recent articles, nowadays exporters are using less LCs in transactions & it is less than one fifth of the cross border sales.

Discrepancy: Discrepancy is defined by the issuing bank as an error or defect in the presented documents when compared to the documentary credit, the UCP 600 rules, or other documents presented under the same letter of credit. Exporters and importers frequently find letter of credit rules to be complex and difficult to understand. Most small and medium-sized export and import businesses do not have enough resources to hire a letter of credit specialist. Letters of credit and standard banking practices are not respected enough by exporters and importers. Exporters and importers believe they can handle letters of credit with ease. However, the truth is quite different. Letters of credit have very strict rules that must be followed. Exporters do not devote enough time to comprehending the letter of credit text before beginning production and shipment. Some banks issue excessively detailed letters of credit. On letters of credit, we occasionally see banks impose nearly impossible conditions on the recipients. Some banks issue hazy (imperfect) letters of credit. Some banks examine documents that do not conform to UCP 600 and ISBP 745.

MOST COMMON DISCREPANCIES

1. The letter of credit has run out of time.
2. Documents are being presented late.
3. Goods were shipped late.
4. Documents with inconsistent spellings of parties' names
5. Terms of sale were not followed.
6. The merchandise description is not strictly in accordance with the L/C term.
7. Partial shipment or transshipment is not specified in the L/C terms.
8. Documents are incompatible with one another.
9. Ocean Unacceptable bill of lading issued by forwarding agent
10. Unclean bills of lading
11. Insurance does not cover the risks specified in the L/C.
12. Insurance is provided after the shipment date.
13. Bills of Lading that have not been properly endorsed

CORRECTABLE DISCREPANCIES

1. The rough draft does not adhere to the L/C terms.
2. The rough draft amount does not match the invoice total.
3. Invoice addressed incorrectly to the account party
4. The description of the goods in the invoice does not match the description in the L/C.
5. The shipping terms are missing from the invoice.
6. Unsigned commercial invoice
7. The Bill of Lading was not approved.
8. Inconsistencies discovered in the documents presented

MAJOR DISCREPANCIES

1. Late delivery
2. The document L/C expired due to late presentation.
3. Bills of Lading issued incorrectly
4. The date on the insurance policy is later than the date on the bill of lading.

Conclusion: Documentary Letters of Credit are used in international trade to reduce the inherent risks of trade for both exporters and importers. However, among other trade-related risks for exporters, the application of the fundamental principle of Strict Compliance to LC operations, which prevents payment to the beneficiary exporter from being made if discrepant documents are presented to the bank, is a source of risk for exporters. Because the documentation process is not entirely under the control of the exporter and some documents, such as insurance, transportation, and governmental documents, are produced by third-party organizations, the exporter has no choice but to find a solution to manage the risk of documentary discrepancy in LC operations in order to receive his payment on time. Current research attempted to find an answer to the question of which risk management method can be used to manage the risk of documentary discrepancy in LC transactions by studying different risk management methods and the applicability of current ERM techniques to LC operation. The research findings support the absence of a specific risk management technique among the various ERM methods that can be applied to the problem of documentary discrepancy in LC operation. The only viable method is the Export Letter of Credit Business Risk Model of Begami, which is based on the Business Risk Model of McNamee 2000; however, its effectiveness requires further investigation.

REFERENCES

- 1) **Alavi, H. (2016)**. Risk Management Techniques and their Application to Documentary Discrepancy in Letter of Credit Transaction. Slovak Republic European Journal Of Economic Studies, 2012, 4-17. doi: 10.13187/es.2017.6.4
- 2) **Islam, S. & Ahamed, S. (2008)**, 'Preventing letter of credit fraud,' DIU Journal of Business and Economics, vol. 3, no. 2.
- 3) **Liu, Z. (2006)**, 'Risk and prevention of bank under L/C', Market Modernisation, vol. 459, no. 2.
- 4) **Hu, Y. (2007)**, 'Soft clause of L/C and risk prevention,' Market Modernisation, vol. 512, no. 2
- 5) **Cheng, Z. (2007)**, 'The risk and its prevention in international letter of credit transactions by exporters,' Science and Educational Innovation, no. 6(March), pp. 220–221.
- 6) **Tao, H. (2009)**, 'L/C fraud and preventive measures in international trade, Modern Business, no. 11, pp. 89–91
- 7) **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>
- 8) **Mann RJ (2000)**. The role of letters of credit in payment transactions, Michigan Law Review, vol. 98, no. 8, pp. 2494-2547
- 9) **SITPRO Ltd. (2003)**. Report on the use of export letters of credit 2001/2002, SITPRO London. 2005, Letters of credit – an introduction, SITPRO Ltd, London.
- 10) **Baker W. (2000)**. Dealing with letter of credit discrepancies. Business Credit, vol. 102, no. 10.
- 11) Dealing with Letter of Credit Discrepancies" by **Baker, Walter** - Business Credit, Vol. 102, Issue 10, November 2000 | Online Research Library: Questia. (2020). Retrieved 29 July 2020, from <https://www.questia.com/magazine/1G1-68279667/dealing-with-letter-of-credit-discrepancies>
- 12) **Zhang, Y. (2011)**. Approaches to resolving the international documentary letters of credit fraud issue. Joensuu: University of Eastern Finland.
- 13) **Nelson, C. A. (2000)**, Import Export: How to Get Started in International Trade, New York: McGraw-Hill.
- 14) **Zhang, Y. (2012)**, "Documentary letter of credit fraud risk management", [Journal of Financial Crime](https://doi.org/10.1108/13590791211266340), Vol.19No.4, pp.343-354. <https://doi.org/10.1108/13590791211266340>
- 15) **King, 2003 – King R. (2003)**. Gutteridge and Megrah's law of bankers' commercial credits. Routledge. p. 14.
- 16) **Ying, Z. (2003)**, 'Documentary L/C fraud: dilemma in prevention,' The Economist, no. 5, pp. 46–48.

17) **Rufus James Trimble**, Harvard Law Review

Vol. 61, No. 6 (Jun., 1948), pp. 981-1008

Published by: [The Harvard Law Review Association](#)

DOI: 10.2307/1336141

<https://www.jstor.org/stable/1336141>

Page Count: 28

18) **Alavi, H., & Kerikmäe, T. (2018)**. Mitigating the Risk of Documentary Discrepancy in Process of Estonian Export Letters of Credit Transaction. *Multidisciplinary Aspects Of Production Engineering*, 1(1), 425-432. doi: 10.2478/mape-2018-0054

19) **Park, K. (2011)**. Non-Documentary Sales Replacing Letters of Credit: Effects of Information Technology, Supply Chain, and Export Credit Insurance. *SSRN Electronic Journal*. doi: 10.2139/ssrn.2007000. file:///Users/harshgup/Downloads/SSRN-id2007000.pdf.

20) **Park, Se-Won, & Choi Jang-Woo. (2011)**. The Effect of Non-documentary Conditions for Letter of Credit and Demand Guarantee. *International Commerce And Information Review*, 13(4), 273-293. doi: 10.15798/kaici.13.4.201112.273.

21) **Alavi, H. (2017)**. Fraud in documentary letters of credit: A comparative study of exercising international legal frameworks. *Bratislava Law Review*, 1(1), 48-69. doi: 10.46282/blr.2017.1.1.65

22) **Alavi, H. (2016)**. Remedies to Fraud in Documentary Letters of Credit: A Comparative Perspective / Opravné Opatrenia Pri Podvodoch S Dokumentárnym Akreditívom: Komparatívna Perspektíva. *EU Agrarian Law*, 5(1), 1-13. doi: 10.1515/eual-2016-0001

23) **Biswas, L. C. (2011)**. Letters of Credit: A Theory on the Legal Basis of the Payment Obligation of Issuing Bank. *SSRN Electronic Journal*. doi:10.2139/ssrn.2043174

24) **Banks and Banking. Effect of Suspension of Letters of Credit by Issuing Bank. (1932)**. *Virginia Law Review*, 18(5), 552. doi:10.2307/1066765

25) **Banks and Banking. Letters of Credit. Insolvency of Issuing Bank. (1931)**. *Columbia Law Review*, 31(8), 1358. doi:10.2307/1114793

26) **Right of Accepting Bank under Letter of Credit to Preference in Assets of Insolvent Issuing Bank. (1932)**. *The Yale Law Journal*, 42(1), 122. doi:10.2307/791424

27) **Park. (2011)**. Liability of Issuing Bank and Confirming Bank in Letter of Credit. *The Journal of International Trade & Commerce*, 7(4), 299-321. doi:10.16980/jitc.7.4.201112.299

28) **Wickremeratne, Rowe, 1998 – Wickremeratne L., Rowe M. (1998)**. The complete guide to documentary credits, Chartered Institute of Bankers, London.