

**UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT  
SGS SOCIÉTÉ GÉNÉRALE DE SURVEILLANCE S.A.**

# **DOCUMENTARY RISK IN COMMODITY TRADE**



**UNITED NATIONS**

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## **PREFACE**

Documents play a major role in international commodity trade - indeed, standard payment procedures (“documentary credit”) rely on them. Nevertheless, in practice, a very large part of commodity transactions result in documents which do not conform to the specifications in Letters of Credit, or are different from those required by the buyer. This causes risks for both buyers and sellers (including the risk of refusal of the cargo, and the risk of non-payment) and can be quite expensive.

UNCTAD, as the focal point within the United Nations system for the integrated treatment of development and interrelated issues in the areas of trade, finance, technology, investment and sustainable development, has an active work programme on commodity trade. At its ninth conference in 1996, UNCTAD gave a new direction to its work on commodities, emphasizing commodity diversification, natural resource development, market transparency, and risk management and finance. In this regard, it is to provide advice to Governments and commodity producers, exporters and importers on the use of risk management instruments. This guide is meant to provide such advice on the very practical area of documentary risk. With a focus on commodity trade, this guide discusses the main documents used in international trade, in particular in relation to standard payment procedures; it then identifies the main areas of documentary risk, the main errors which occur, and ways to reduce documentary risk.

The publication of this document has been largely financed by the Société Générale de Surveillance S.A. (SGS), the world’s largest international inspection, testing and verification organization. As one of its core activities is inspection and monitoring in connection with trade and shipping of commodities, as well as manufactured goods, it establishes many of the documents that are used, on a day-to-day basis, in international trade.

It is hoped that this paper is of practical use to exporters and importers of commodities and, in particular, to the many new companies that have been created following the worldwide withdrawal of governments from commodity trade.

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## Chapter I

### AN INTRODUCTION TO DOCUMENTARY CREDITS

#### A. General introduction

The documentary credit system has been used for over a hundred and fifty years, and still plays a major role in international trade. Letters of credit have been estimated to represent more than US\$100 billion in banking obligations annually. At least 60 per cent of commodity trading is conducted through letters of credit.

Documentary credit is an essential part of the export process. It is a trade finance mechanism that was developed to add a measure of security to trade transactions, particularly between buyers and sellers from different countries, and to assert sufficient pressure in case of any violation or non-performance to the trade contract. The letter of credit calls for the participation of a third party, which is the bank. The bank provides additional security for both parties; it plays the role of an intermediary, by assuring the seller that he will be paid if he provides the bank with the required documents, and by assuring the buyer that his money will not be paid unless the shipping documents evidencing proper shipment of his goods are presented.

There are initially three parties involved in documentary credit, the issuer (issuing bank), the account party (buyer/applicant), and the beneficiary (seller). Three agreements represent the relationship between the parties, a trade contract between buyer and seller, the documentary credit between the issuing bank and the seller<sup>1</sup>, and a reimbursement agreement between the issuing bank and the buyer. Although the three agreements are related to the same transaction, each of them is independent, and the breach of one agreement may not constitute breach of another agreement.<sup>2</sup>

There are strict requirements that govern the formulation of documentary credit. The International

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<sup>1</sup> If the documentary credit is confirmed by another bank, then such bank undertakes its own contractual arrangement, in addition to that of the issuing bank, to the beneficiary.

<sup>2</sup> For further information related to contractual arrangements, refer to UCP 500 Article 3.

#### Box 1

##### Definition of documentary credit

Documentary credit or letter of credit is an undertaking issued by a bank (*Issuing bank*) for the account of the buyer (*the Applicant*) or for its own account, to pay the Beneficiary the value of the Draft and/or documents, provided that the terms and conditions of the Documentary Credit are complied with.

Source: ICC Guide to Documentary Credit Operations. For further detailed explanation of the definition refer to **UCP 500 Article 2.**

Chamber of Commerce is the organization which has developed the most extensive and most commonly applied rules, models, and materials related to documentary credit.

## 2. The role of the International Chamber of Commerce (ICC)

The International Chamber of Commerce (ICC) is a non-governmental organisation which was founded in 1919 with the aim of facilitating and helping the world's businesses, by promoting trade, investment, and open markets for goods and services, as well as the free flow of capital.

ICC has large international committees composed of top business, legal, and private sector experts. They provide policies for the world business community on taxation, banking, international investment, sea and air transport, marketing, intellectual property, the environment and all trade and management issues. In addition they harmonize trade practices and draw up voluntary codes for business which set ethical standards.

Box 2
<b>What is the ICC?</b>
<b><i>The World Business Organization</i></b>
<ul style="list-style-type: none"><li>• promotes international trade, investment and market economy system worldwide;</li><li>• makes rules that govern the conduct of business across borders;</li><li>• provides essential services, foremost among them the ICC International Court of Arbitration.</li></ul>
Source: ICC.

Among the most well-known ICC products in relation to international trade practices are the ***Incoterms*** and the ***ICC Uniform Customs and Practice for Documentary credit (UCP)***. Their objective is to facilitate trade, increase the efficiency and decrease the cost of international transactions by promoting the standardization of international banking and commercial practices and procedures.

### 1. *Incoterms*

In order to facilitate communication and trading among companies, the ICC published in 1936 a set of rules specifying contract obligations and assigning the responsibilities of buyers and sellers involved in international trade. These so-called Incoterms (**I**nternational **C**ommerce **t**erms) have been updated regularly since, most recently in 1990 (with 13 standardized foreign sales terms) to reflect new techniques of international trade. Incoterms are uniform sales terms used in foreign trade and are accepted by the banks as legal terminology for letter of credit transactions. They provide clear explanations as to the terms of sales and obligations of parties to a letter of credit (in terms of who does what and who pays for what).

Incoterms are the international standard used in the sales transaction and shipping documentation. As mentioned earlier, Incoterms define the seller's and buyer's responsibilities in relation to the transport of the goods being traded. They also explain the division of costs and risks between the parties.

Incoterms provide generally three basic pieces of information:

- ◆ *Information on the transfer of risk* → it defines at which place the risks of cargo loss and



damage is transferred from the seller to the buyer during transport operations.

- ◆ *Information on the division of costs* → it defines how costs resulting from the transport operation are shared between the buyer and seller (i.e. cost of dispatch, carriage and delivery; customs clearance for export and import; service or assistance rendered by one party to the other; and insurance).
- ◆ *Information on the documents* → it defines who will provide the required documents (i.e. transport document, proof of delivery, certificate of inspection, insurance, etc.).

Incoterms are generally letters or abbreviations that are global and have a universal meaning as to responsibility of the parties, terms of sale, point of origin, and destination. These terms are very

### Box 3

#### Incoterms - the terminology

Incoterms distinguish between a “shipment contract” and an “arrival contract”. In a “shipment contract”, goods are carried on the main transport mode at buyer’s risk. In an “arrival contract” goods are carried on the main transport mode at seller’s risk.

The 13 terms of Incoterms (abbreviated by three English-letter acronyms) are grouped into four different classes:

**Group E: *Departure term.***

Where the seller makes the goods available to the buyer at his premises (**EXW - Ex-Works**). Compared to other Incoterms, with this clause the seller has the least obligations.

**Group F (for “Free”): *Shipment terms - Main carriage unpaid.***

Where the seller is required to deliver the goods to a carrier for shipment (**FCA - Free Carrier, FAS - Free Alongside Ship, and FOB - Free On Board**). These refer to shipment contracts with the shipment point named and carriage unpaid by the seller. The seller here bears neither risks nor main transport costs.

**Group C (for “Cost”/“Carriage” terms): *Shipment terms - Main carriage paid.***

These refer to shipment contracts under which the seller has to incur the costs for carriage, but without assuming the risks of loss or damage to the goods or any additional costs due to incidents occurring after shipment and dispatch (**CFR - Cost and Freight, CIF - Cost, Insurance, and Freight, CPT - Carriage Paid To, and CIP - Cost and Insurance Paid To**). In these cases, the seller bears the main transport costs but not the risks.

**Group D (for “Delivered”): *Arrival Terms.***

These refer to arrival contracts under which the seller bears all risks and costs needed to bring the goods to the country of destination (**DAF - Delivered At Frontier Arrival, and DES - Delivered Ex Ship, DEQ - Delivered Ex Quay, DDU - Delivered Duty Unpaid, DDP - Delivered Duty Paid**). For the last four, the seller bears costs and risks on the main transport. **DDP** attributes to the seller the maximum obligation of placing the goods in the buyer’s premises after discharging from the carrying vehicle. It is the opposite of **EXW**.

Source: *Multimodal Transport Handbook for Officials and Practitioners*, UNCTAD, 1996.

common in international trade and have to be clearly understood. When parties decide on a given Incoterm, they are implicitly agreeing to a set of obligations; these obligations need not be referred to

again in the sales contract.

The Incoterms are in synchronization with the Vienna Convention, the UN law on contracts covering the international sales of goods. Since Incoterms are not law, they must be written into a sales contract in order to be bound to a contract. It should be noted that Incoterms are flexible and can be further defined to suit the mutual interest of the buyer and seller.

NOTE: The buyer and seller should apply only be very careful in choosing the appropriate Incoterms to be used for a specific transaction, how to implement it and the necessary information handling conditions before addressing a particular Incoterm, the buyer and seller must be very precise in defining:

## 2. UCP 500

ICC has established a set of standard (bankers') rules and practices called the "Uniform Customs and Practices for Documentary Credits" (UCP) to govern trade transactions.<sup>3</sup> The UCP describes customary practices and standard performance for letters of credit and provides a comprehensive and practical aid to bankers, lawyers, and all businesses involved in international trade. The UCP lays down a code of practice for the issuing of documentary credits. For many years most documentary credit transactions have been carried out in accordance with the "Uniform Customs and Practice for Documentary Credits". Letters of credit are reviewed by all banks according to these rules, and persons dealing in letters of credit should be well-aware of them.

The UCP of 1993 (ICC publication no. 500) contains 49 articles under seven headings:

1. General Provisions and Definitions
2. Forms and Notification of Credit (provides consistent standards in connection with the issuance, amendment, advisement, payment and confirmation of letters of credit)
3. Liabilities and Responsibilities
4. Documents (defines the elements of acceptability and content of each type of transport document)
5. Miscellaneous Provisions
6. Transferable Credit
7. Assignment of Proceeds.

The objective of the new UCP is to enhance international trade and facilitate the use of letters of credit by reducing the level of discrepancies and disputes. It should be noted that not all banks in the

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<sup>3</sup> The code of UCP that has been published by the Banking Commission of the International Chamber of Commerce (ICC) has been modified five times, with the latest version dating from 1993 (UCP 500), to faithfully reflect international practices related to credit documentation. UCP 500 came into force on January 1st 1994.

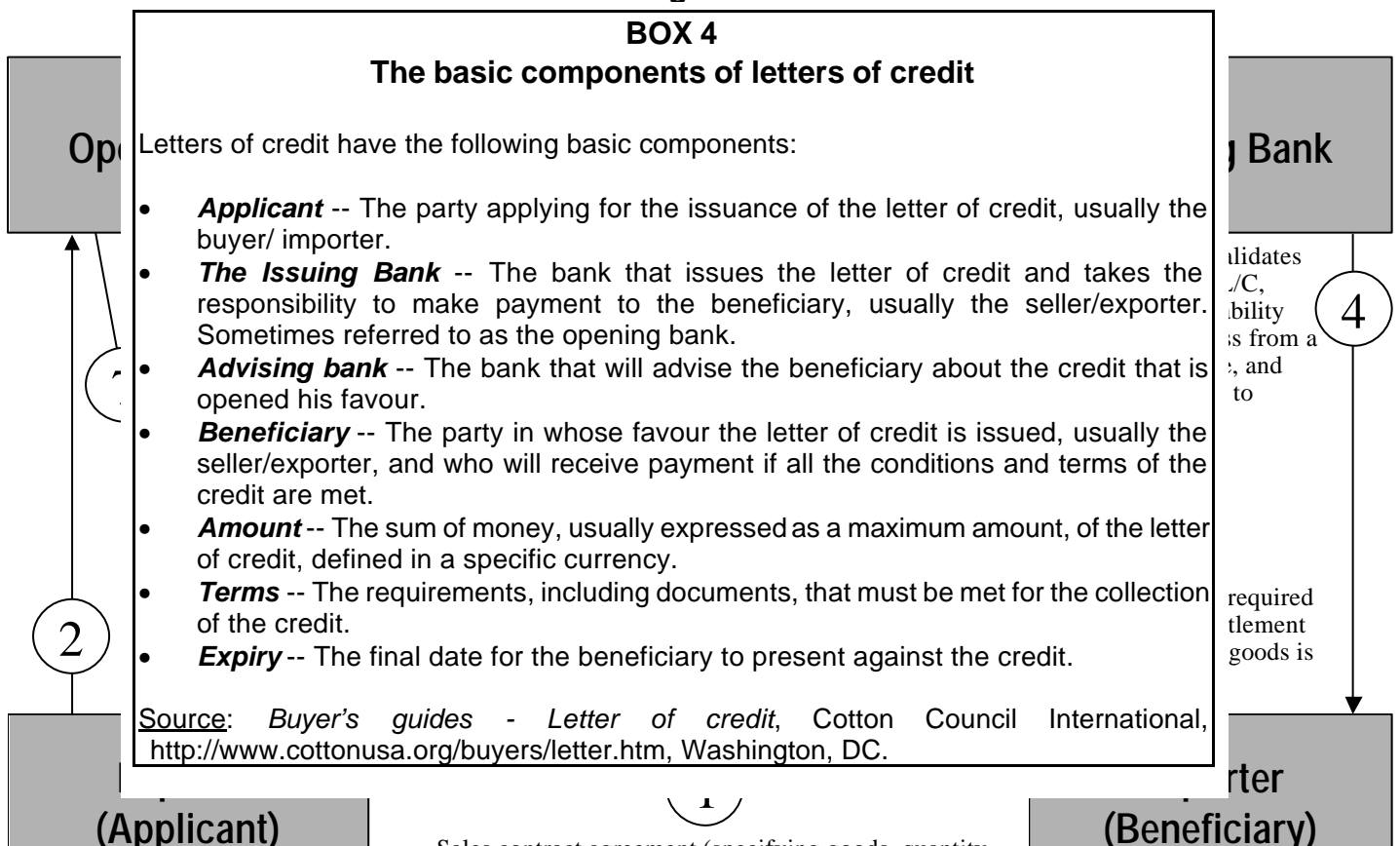
world conform to the UCP rules but, in principle, it is clearly stated in Article 1 of UCP 500 that UCP rules apply to a documentary credit when they are included in the contract. Therefore, it is always preferable to refer to the UCP when setting up a contract.

### C. The letter of credit

The purpose of a letter of credit is for the issuing bank to substitute for the credit-worthiness of the buyer. As defined earlier, a letter of credit assures the seller that payment will be made against the merchandise shipped, on condition that the documents presented are in compliance with the letter of credit terms. The seller is thus protected from buyer credit risks as the issuing bank is providing a guarantee of payment.

Unless otherwise specified the letter of credit is considered to be irrevocable, that is: it cannot be changed unless both the buyer and the seller agree to make changes (Article 6 of UCP 500). It is not advisable to use a revocable letter of credit.

Figure 1



An *irrevocable and confirmed letter of credit* gives the strongest guarantees, and thus is more expensive than a simple irrevocable letter of credit. An (irrevocable) confirmed letter of credit is basically used when the parties are dealing for the first time with each other, or when the seller is not

sure about the credit-worthiness of the buyer's bank (or sometimes may not even be sure about the situation of the buyer) and also because there may be concern about the political or economic risks in the country where the bank is situated (confirmation in that case is applied to cover political risks even if the bank issuing the letter of credit is a first-class bank). As many banks in developing countries have insufficient capital, their ability to guarantee letters of credit is sometimes doubtful. Therefore, in order to have an additional source of security, confirmation of a letter of credit is sometimes required and can be obtained from local financial institutions or international banks; but still, many banks are unwilling to assume these risks. Some banks may refuse to confirm letters of credit issued by banks in countries with high political risks; however, there are banks which can provide such confirmation through the specific lines of credit they have in place for a particular country (usually limits are very low and fees could be very high).

A letter of credit is not an absolute guarantee of payment but rather a payment mechanism which can reduce the risk of not getting paid. Any misspelling or discrepancy in the letter of credit incurs delays and additional costs to the transaction, or can also be used as an excuse for non-payment. Common discrepancies in a letter of credit can be as simple as an incorrectly stated name of the beneficiary to a late shipment date which makes the letter of credit invalid to the seller.

It should be remembered that, in a letter of credit transaction, conforming documents imply payment. What is and what is not a discrepancy is determined by the UCP articles, and the terms of the letter of credit. Discrepancies are also discerned through practice and experience. Lack of training and improper understanding of letters of credit administration can lead to problems and rejection. Training is a key component in achieving greater efficiency in completing letters of credit properly. Accuracy in properly completing a letter of credit is a vital requirement to avoid problems and corrections, thus saving time and money (improving cash flow and enhancing profitability). Checking procedures need to be carried out at a very early stage of the transaction.

When checking documents, the issuing bank will check the documents against the terms and conditions of the letter of credit. If any discrepancy is noted, the buyer will be notified as soon as possible and will be given the opportunity to decide whether or not to accept the documents despite the discrepancies. If the documents are accepted by the buyer, the issuing bank will then notify the seller's bank that the letter of credit will be honoured despite the discrepancies. On the other hand, if the documents are rejected, then the issuing bank will issue a notice of rejection to the seller's bank within seven banking days from the date the issuing bank received the documents (chapter three provides a general explanation on the most common discrepancies that may occur when preparing documents for presentation and how to resolve them).

**NOTES:** If the seller, after shipping the goods, has problems in getting paid under the letter of credit, it is important then for him to be vigilant in checking on the status of the goods he has shipped; make sure about the condition of the goods (where they are located, whether they are properly stocked,..) and most importantly make sure that the goods are properly insured. In case of dispute, the buyer can sell his merchandise to a different party, provided that the goods are still in good condition. If he is paid less than what he was supposed to receive from the first buyer, he can then claim the difference through arbitration, provided that the buyer has breached the contract without apparent justification.

The letter of credit should indicate that it will be covered by the principles of the UCP 500. It may also be important to specify that transaction and arbitration are covered by the United Nations Convention on contracts for the international sale of goods, commonly referred to as the Vienna Convention.

As to the sales contract, most commodity trade contracts follow a range of standard forms of contracts, generally established by trade associations. For instance, it has been estimated that 80% of the 180 million tonnes of cereals traded annually worldwide moves on GAFTA (The Grain and Feed Trade Association) contracts, as does a significant proportion of the world's trade in feeding stuffs and pulses.<sup>4</sup> Similarly sugar trade is normally governed by a set of standard contracts set by an organisation similar to GAFTA, cocoa trade by the Cocoa Association of London, Coffee by the European Contract for Coffee or the Green Coffee Association of New York, FOSFA (Federation of Oil, Seeds and Fats Associations) contracts for oil, seeds and fats, etc.

The standard forms of contract are aimed at facilitating trade; generally speaking, they cover the basis of quality grading, delivery terms, provide protection, advice with regards to insurance and to appropriate payment, and include an arbitration clause and provisions in case of default.<sup>5</sup> These standard forms of contract generally meet the requirements of trade and their terms and conditions reflect customary trade practices. They are not imposed by the associations which provide them. Contracting parties usually select in full or in part one of these contracts as the basis of their sales agreement. It is always recommended to use these types of contract since they have the advantage of helping to reduce risks and discrepancies.

## **D. General guidelines for using a letter of credit**

### *1. Guidelines for the seller*

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<sup>4</sup> Source: *GAFTA*. GAFTA is an international organisation with more than 700 Member companies in 75 countries. Members of the Association are involved in trading grain, animal feeding stuffs, pulses and rice at all stages of the supply chain from production to final consumption. They are trading companies, brokers, and associate members - superintendents, banks, analysts, arbitrators, professional firms and solicitors - who provide services to trade. The services that the Association provides to its Members can be divided into three main areas: Trade Policy and Current Affairs, Technical Services (contracts and arbitration services), and Training.

<sup>5</sup> See the annex 1 for an example of a GAFTA standard contract form "FOB Contract for Thai rice".

1. The seller should carefully assess the credit-worthiness of the buyer, the buyer's bank, and the risk in the buyer's country. Normally, it is the seller's bank which should assist the seller in the inquiry. Financial strength of the bank issuing the letter of credit must be examined, and if necessary a credit may have to be confirmed (for instance if a smaller bank is involved in the transaction, depending on the country of origin, the credit may have to be confirmed by a large bank).
2. The seller should carefully review the letter of credit to make sure that all the details and conditions stipulated can be met (type of credit, schedules of shipment, expiry date, quality and quantity of goods<sup>6</sup>, packaging and documentation). Documentary credit is a separate transaction from the underlying sales contract. It is usually during the negotiation stage of the sales contract that the responsibilities of both the seller and buyer are defined and most of the terms and conditions of the documentary credit are agreed upon. Therefore, it is very important for the seller to be fully aware of all terms and conditions that need to be fulfilled before the application for a letter of credit is made. It is the seller's responsibility to examine the letter of credit thoroughly to assure its workability (he may get the assistance of a forwarder).
3. All aspects of the letter of credit must conform with the terms agreed upon and should match the terms and conditions of the sales contract, the amount to be paid, transport means, etc. (including seller's name and address which should match the name on the invoices, packaging list, and other shipping documents as well). Therefore, it is more convenient for the buyer to receive a completed copy of the letter of credit application before the buyer submits it to his bank, to make sure that all terms and conditions can be met. Sometimes it is recommended to give a general description of the merchandise in order to avoid discrepancies.
4. If any of the terms or conditions of the credit need to be modified, the seller should get in touch with the buyer as soon as possible so that the buyer can instruct the issuing bank to make the necessary amendments. For example, if an extended period is required in relation to credit expiration or shipment dates, the seller should request his buyer to arrange for the required extensions immediately. The credit expiration and shipment dates should be considered and decided upon if shipment can be made and documents presented for payment before the specified dates.

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<sup>6</sup> Article 39 of UCP 500 allows, unless otherwise stipulated, for a variance in the quantity of plus or minus 5% against what is stipulated in the letter of credit. This variance is not authorized if the quantity of goods in the letter of credit is stipulated in specific number of packing units or individual items. But in any case the amount of drawing should not exceed the credit amount. If the letter of credit stipulated "about" or "approximately", then a 10% variation in the amount, or quantity, or unit price is allowed.

### Box 5

5. The seller should have a correct amount of drawings specified in the letter of credit (usually an optimum amount is stated), banks pay only the amount specified in a letter of credit, even if higher charges for shipping, insurance or other factors are advanced. If the word “approximately”, “about” or “circa” is used, a variance (usually a variance of plus/minus 10%) is permitted.<sup>7</sup> If the seller is making a CIF shipment under a sales contract, he should be aware of the amount of the credit and whether the credit covers sufficiently the payment for the merchandise, plus all shipping, insurance and freight charges.
6. If the letter of credit is denominated in a foreign currency, the seller should consider a foreign exchange contract to cover currency risks.

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<sup>7</sup> *Guide to documentary credit in foreign trade: documentary credits, documentary collections, bank guarantee*, UBS, 1995, Switzerland.

## BOX 5

### The two fundamental principles of letters of credit

Letters of credit are based on two principles:

- (i) **Autonomy**
- (ii) **Doctrine of strict compliance**

#### (i) The autonomy of the letter of credit

According to this principle, the letter of credit is disassociated from the actual sales and other contracts and, thus, is not affected by any problems and disputes related to the contracts or dissatisfactions between the exporter and buyer. The main and only agreement that is arranged between the exporter and the bank is the letter of credit. Under a letter of credit, the bank is only concerned with one problem: to check whether the documents presented by the buyer comply with those specified in the letter of credit. Because of the autonomy of a letter of credit, the buyer's bank is therefore absolutely bound to honour the letter of credit by paying the exporter upon presentation of proper documents, notwithstanding any dissatisfaction from the buyer in relation to the sales contract or any dispute between the buyer and seller. The buyer's protest about the export cannot suspend payment of the letter of credit. This was the case with one exporter's bank.

It successfully sued a buyer's bank for dishonouring drafts against a letter of credit because of complaints about the quality of the exported goods. The only case where a bank may refuse payment is in case of fraud or forgery in the transaction, referred to as "fraud exception". (Articles 3 and 4 of UCP 500 refer to the principle of autonomy of the letter of credit).

#### (ii) The doctrine of strict compliance

According to this principle, the exporter must respect the written terms "to the letter" of the letter of credit. If any discrepancy or inconstancy occurs between the documents presented by the exporter and what is actually specified in the letter of credit, the bank can refuse payment. Therefore, with a letter of credit, the buyer has the protection of the bank strictly controlling the documents, and the seller has the protection of getting paid if all documents comply with the letter of credit. But the problem is how strict compliance should be. Some courts insist upon literal compliance, so that a misspelled name or typographical errors may be a divergence to refuse payment. Others accept payment upon substantial compliance with documentary requirements. However, one should keep in mind that the bank may insist on strict compliance with all the requirements of the letter of credit, and therefore the beneficiary must be able to provide prompt documentation. As the seller has very limited defence to protect himself, he should check with his bank whenever he has any doubts in interpreting unclear items in the letter of credit.

7. The seller should be aware of the importance of dates and schedule. Tight timing and schedule lead to problems, it does not really mean that it will accelerate shipment and deliveries. On the other hand, it is not appropriate to ask buyers for expiration dates far beyond what is reasonably needed, as it ties up the buyer's credit lines or cash collateral at his bank. As a seller, one should consider the following issues regarding latest ship dates:<sup>8</sup>

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<sup>8</sup> Cambridge Trading Services Corporation, *Letters of credit*, <http://www.cambtrade.com/LCSindex.html>, Boston.



- Consider the time it takes to manufacture/produce (if required) and move the product from an inland origin point to the port or airport of departure. The method of carriage, usually truck or rail, is a factor as are weather and time of year.
- Perishables generally are given priority over non-perishables in airfreight shipments. In other words, there is a risk of delay if the exporter wishes to air-freight non-perishables.
- High value ocean container cargoes can be given priority, by shippers, over low value ocean container cargoes.
- For a given shipping location, air and especially ocean freight services have different departure frequencies to different destinations. From a given location, there may be air service daily, and ocean service weekly. Allow enough time to miss a flight or sailing. The more remote the destination, the less frequent the departures.
- Air and ocean carriers often require the freight to be in their possession several days in advance of the departure date to allow time for loading. This "cut off" date is critical in ocean shipments. Also, it is important that the seller arrange specific bookings for ocean freight in advance and have written booking confirmations.
- The seller has to make sure that the freight forwarder has seen a copy of the letter of credit and is committed to meeting the shipping requirements of the credit, and preparing the Bills of Lading and other documents in a timely fashion, in strict conformance with the letter of credit. It should be noted that in some cases, buyers would intentionally embroider the truth and would require documents that are difficult to obtain. In that case one should take into consideration the delays in providing those documents.

**BOX 6**  
**Key letter of credit dates**

Key letter of credit dates include :

- *Opening Date*: Shipping documents generally may predate the opening date of the letter of credit unless specifically prohibited in the letter of credit.
- *Latest Ship Date*: Shipping documents must be dated on or before this date. It specifies the latest date by which a seller must ship the goods. If the goods are not shipped before the specified date then a discrepancy will occur and the seller may not get paid from the letter of credit.
- *Latest Date to Present Documents*: Shipping documents must arrive at the bank before this date, if stated. If not specifically stated the documents must arrive at the negotiating bank at most 21 days after the latest ship date but before the expiration date of the letter of credit.
- *Expiration Date*: Usually the last day to present documents in strict compliance with the terms of the letter of credit (UCP, Article 42a). The letter of credit essentially ceases to exist on this date.

Source: *Letters of credit*, Cambridge Trading Services Corporation, <http://www.cambtrade.com/LCSindex.html>, Boston.

8. The seller should be familiar with foreign exchange limitations in the buyer's country; otherwise payment procedures could be hindered.
9. As a seller, one should always insist that the payment documents on any letter of credit are negotiated and reviewed in his own country. The seller should not accept letters of credit which

require that documents be sent abroad for negotiation.

10. The seller should always request that the letter of credit specify whether partial shipments and transshipment is allowed in order to avoid unexpected problems. In case partial shipment is allowed, the validity of the letter of credit will not be affected even if a problem arises in meeting the delivery date.<sup>9</sup>
11. It is important for the seller to make a delivery obligation dependent on the receipt of the letter of credit in “good order”, (i.e. the seller does not have the obligation to deliver the goods if the letter of credit does not contain all the elements that have been agreed upon). This condition should be specified in the letter of credit.
12. The last point in this brief overview is in relation to confirmation; it is recommended that the exporter always ask the buyer which bank he will be dealing with to open a letter of credit. The exporter should then ask his bank (advising bank) whether they will accept to confirm a letter of credit from the specified opening bank with the specified amount. If the bank approves, the exporter should instruct the buyer to have the letter of credit advised and confirmed through the seller’s bank. If the seller’s bank refuses to confirm the letter of credit,

**NOTES:** In many cases it is recommended to ask for confirmation on a letter of credit. A confirmed letter of credit from a first-class bank is a solid guarantee. By the confirmation process, the confirming bank is taking on the risk of non-payment of the issuing bank and other risks associated with the country where the issuing bank is located. The following factors have to be taken into account:

☞ *If the country is less developed or politically unstable*, the letter of credit has to be confirmed. Consideration must also be given to the bank issuing the letter of credit (the financial strength of the issuing bank is rigorously examined). If the client is a reliable partner or the bank issuing the letter of credit is a first-class bank then an unconfirmed letter of credit may be accepted, notwithstanding the country risk. If it is a local bank or a local subsidiary (or branch) then confirmation may be required from the headquarters office. However, a confirmation from the overseas office of the issuing bank may remove some of the country risks but will not remove the credit risks related to the issuing bank. If a trader is dealing with a risky country then a confirmation is required unless the bank that is issuing the letter of credit is not located in the country itself.

☞ *If the origin country is developed and stable*, the letter of credit does not have to be confirmed, unless the issuing bank is a small bank or the party (buyer) opening the letter of credit is a new business partner.

the seller may obtain confirmation from another bank (the buyer’s correspondent bank in the exporter’s home country, for example). However, it is more convenient to involve only two banks whenever possible.

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<sup>9</sup> *Training Handbook on Export Documentation*, ITC, Geneva, 1994, p.78.

## *2. Guidelines for the buyer*

1. Before opening a letter of credit, the buyer should come to an agreement with the seller on all aspects of quantity and quality of goods to be sent, schedules of shipment, payment procedures, and documents to be supplied. As with the seller, it is very important for the buyer to be fully aware of all terms and conditions that need to be fulfilled before the application for the letter of credit is made.
2. When dealing with letters of credit, the buyer should take into consideration the standard payment methods in the country of the seller.
3. When setting the dates in the letter of credit, the buyer should define a tight but reasonable shipping schedule. If dates are improperly set, this will lead to amendments to the letter of credit leading to additional costs, or simply to non-shipment.
4. The buyer should be prepared to amend or renegotiate terms of the letter of credit with the seller. Amendments are a common procedure in international trade.
5. In order to eliminate foreign exchange risk, the buyer may cover himself by using the futures/forward markets.
6. The letter of credit validity should give the seller enough time to produce and ship the goods. With the expiry date and the latest shipping date, the buyer should give the seller ample time to present documents to the bank. For instance, several countries, particularly those in the Middle East, require that documents be "legalized". This requires that some of the documents be sent to the destination country's consulate, in the country of origin, for a stamp before presentation. This is a routine procedure, but it adds a few days or more to the time needed for presentation.
13. As a general rule, the commercial contract should clearly specify the party responsible for appointing the confirming bank and the party who will pay for the confirmation. Therefore, the buyer should agree in advance that the confirming bank may be chosen by the seller. Most commonly, it is the buyer who bears the cost of confirmation. However, if the buyer is a small company, it is reasonable for the seller to bear the security of confirmation and its costs. This can be stated in the letter of credit.

## BOX 7 Types of Letters of Credit

### ➤ Basic letters of credit

#### ***Revocable Letters of Credit***

The term "revocable" means that the letter of credit can be modified or cancelled by the buyer or his bank at any time without prior notice to the seller. It offers no guarantee of payment. Therefore, because it offers little security, revocable letters of credit are rarely acceptable by sellers or used in international trade.

#### ***Irrevocable Letters of Credit***

Under this type of credit the buyer's bank has made an irrevocable commitment to pay the seller, on his proof of compliance with the stipulated conditions of the letter of credit, and this can not be changed or cancelled by the bank without permission of the exporter. It offers a guarantee of payment. Therefore, because of the security it offers, irrevocable letters of credit are widely used in international trade. They are more expensive since the issuing bank is guaranteeing the credit.

#### ***Confirmed Letters of Credit***

This term means that the credit is not only backed by the issuing bank, but that payment is also guaranteed by the confirming bank (which may be the advising/notifying bank). Thus the confirming bank is adding its guarantee to pay the seller in case the issuing bank fails to make payment. If a seller is unfamiliar with the buyer's bank (or even the buyer) which issues the letter of credit, or if he is trading in a high risk area, he may then insist on an irrevocable confirmed letter of credit. A confirmation on a letter of credit adds costs because the confirming bank has added liability.

#### ***Unconfirmed Letters of Credit***

This means that the issuing bank is the only party responsible for payment to the supplier. The seller's bank does not add its guarantee of payment and is obliged to pay only after the payment from the issuing bank is received. In case of difficulties the exporter must look to the issuing bank for payment. The most desirable type of credit is the "Irrevocable Confirmed" Letter of Credit, but this is not always available.

### ➤ Special types of letters of credit

#### ***Revolving Letters of Credit***

A revolving letter of credit covers multiple or continuous shipments of merchandise. It is a commitment on the part of the issuing bank to make the L/C available in the original amount whenever it has been used or drawn down, usually under the same terms and without the issuance of another L/C. Revolving L/Cs enable sellers to rely on ongoing sources of short-term financing. But while they avoid the fixed costs of entering each time into a new short-term financing transaction, revolving credits cannot replace longer-term financing. The number of times the L/C can be utilized and the period of validity is specified in the L/C. A revolving letter of credit can be either cumulative or noncumulative; cumulative means that the unused sums in the L/C can be added to the next installment, whereas noncumulative means that partial amounts not used in time expire.

#### ***Back-to-Back Letters of Credit***

Back-to-back letters of credit can be used by trading companies which arrange transactions for the sale of goods between two other parties, or by processing companies. They enable the trading company to use a first L/C, issued in his favour by the buyer, as collateral for his issuance of a second L/C in favour of the supplier. Thus a new L/C is opened on the basis of an already existing one.

#### ***Transferable Letters of Credit***

Transferable letters of credit are an alternative to back-to-back L/Cs as a method of facilitating transactions arranged by a trading company. The first beneficiary (the trading company) instructs the advising bank to advise the letter of credit (i.e. to transfer all or part of the proceeds of the L/C) to the second beneficiary (the ultimate exporter).

### ➤ Special clauses

#### ***Red-Clause Letters of Credit***

Red-clause letters of credit enable an exporter to obtain pre-shipment finance (which is a percentage of the L/C amount) from the buyer through the opening bank and against the advising bank's guarantee of reimbursement, either (i) against a simple written statement of purpose (clean red clause) or (ii) against his undertaking to provide certain specified documents.

#### ***Green-clause Letters of Credit***

Green-clause letters of credit serve the same purpose as red-clause L/Cs but differ in that the exporter can only obtain advance payments against production of warehouse receipts (and/or related documents) evidencing that the goods are held to the order of the buyer/opening bank/advising bank until the required documents are received. In this respect, green-clause letters of credit are very similar to inventory financing, although most of the comments made about red-clause L/Cs also apply here.

In order to achieve a clear trade transaction, parties involved in trading should be fully aware of the functioning of the letter of credit and the rules that govern it (basically the UCP 500). Letters of credit are at times not even known or well understood by traders. Therefore, training is a key component in achieving a greater efficiency in dealing with letters of credit. Research conducted by SITPRO, the UK's Trade Facilitation Agency, has revealed that quite a large proportion of documents presented under letters of credit are rejected for errors which could have been easily avoided if the documents had been more thoroughly checked before being presented to the banks. Lack of training and understanding how to properly administer letters of credit are serious problems which obstruct the proper functioning of the credit transaction. Thus, several trade facilitation agencies, export associations and banks have produced several letter of credit checklists, training and even software to assist people involved in international trade to get their letters of credit transactions properly conducted. Most of these checklists are consistent with UCP 500.

On the other hand, big trading companies have understood the importance of getting the letters of credit right and have created in-house control sections that deal only with documentary credit; in other words, the trading function and the documentary function are separated. As a trader, one can manage the risk involved in the business, but only if one has the staff that knows how to handle letters of credit issues.

**BOX 8**  
**Methods of settlement**

According to UCP 500 (Article 10), payment under documentary credit may be available under four terms:

**\_ By Sight payment**

Payment is made to the seller by the issuing or confirming bank immediately upon presentation and examination of the documents (the documents may or may not include a bill of lading).

**\_ By Deferred Payment**

Payment is made to the seller at a specified future date, for example 60 days after presentation of the documents or after the date of shipment (i.e. the date of the bill of lading).

**\_ By Acceptance**

This type of credit requires the exporter to draw a usance draft (bill of exchange) either on the issuing or confirming bank. The draft is accepted by the bank for payment to be made at a future fixed date. For example, payment date under an acceptance credit may be after 90 days from presentation of the documents or from the shipment of goods.

**Note:** *Deferred and Acceptance credits (i.e. term credits) are considered to be financing instruments for the buyer, since during deferred payment the buyer can often sell the goods and pay the amount due with the proceeds.*

**\_ By Negotiation**

A credit payable at sight or at usance can be negotiated, either with a freely chosen bank or a bank that is specifically nominated by the issuing bank. Under negotiation, three payment options may occur:

1. The negotiating bank would pay the beneficiary only when it receives payment from the issuing bank. The seller would present the documents to the advising bank for payment. The negotiating bank would in turn forward the documents to the issuing bank claiming payment and would pay the seller on receipt of payment by the issuing bank. Payment is made by the issuing bank on receipt of proper documents.
2. The negotiating bank would negotiate the documents by “giving value” to the documents, and paying the beneficiary the value of the documents less a charge (i.e. discounting the documents), while awaiting reimbursement from the issuing bank. When the negotiating bank “gives value” to the documents, it does not receive immediate payment itself, therefore it will deduct interest to cover the period between paying and receiving payment from the issuing bank. The bank may agree to advance payment *without recourse* which means that the bank will not have the right to get reimbursement from the beneficiary, if payment is not received from the issuing bank as expected. In that case the negotiating bank is advancing the payment at its own risk.

**Note:** *The negotiating bank may be the confirming bank and therefore bound to negotiate confirming documents upon presentation and without recourse to the seller.*

3. The negotiating bank would offer to give value if it is prepared to accept the payment risk of the issuing bank. The bank may agree to advance payment *with recourse* to the seller for reimbursement.

## Chapter II

### THE ROLE OF BANKS

International trade is considered by bankers as a low risk area, compared to other forms of bank lending. This is essentially due to the basis of the trade deal; short-term, self liquidating (e.g., banks finance the import of goods which are then resold to repay the bank), and secured (by the underlying goods). Nevertheless, there are some risks factors related to international trade and banks are very diligent in assessing those risks.

In some trade negotiations, bankers will recommend the use of a letter of credit since it will help facilitate trade and reduce risks. Nevertheless, it should be noted that banks are mostly intermediaries: they are responsible for the financial aspect of the transaction. They are not legally liable for the authenticity of the goods; however, they have the duty of due diligence and the obligation to pay upon proper receipt of the required documents.

The first part of this chapter focuses on the main areas of risk in international trade finance and how banks in general try to counteract them. The second part will focus on the support these banks can provide to importers or exporters to help them succeed in international trade transactions.

#### A. Risks assessment

Macro risks and transactions risks are the major risks assessed by banks when financing international trade:

- Macro risks can be defined as the external factors which may have a negative impact on international trade transactions.<sup>10</sup>
- Transaction risks can be defined as the internal factors which may influence the overall performance of the transaction.

##### 1. Macro risks<sup>11</sup>

Risks in international trade vary continuously, so the initial step for any bank dealing in international trade is to analyse country risks and foreign banks' risks in order to identify the ones they will be dealing with. Next, they need to define the credit limits available for dealing with each of these countries and banks.

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<sup>10</sup> Micro risks can be added to macro risks, where the financial status and operational risks associated with the business of the client are defined.

<sup>11</sup> This section is based on *Risk involved in international trade finance: a banker's perspective*, by Peter J. Boland, 1997, International Trade Association, URL: <http://iami.org/ita/news/it06-.html>.

### a. Country risk

Banks in general set country credit ceilings. The factors that influence the ceilings are the country's political and economic stability; its foreign debt commitments and its track record in meeting its past commitments; exchange controls if any; and the country's penchant for protectionism of domestic industry. All these elements will determine whether the country can and will honour its payment commitments in time.

Most banks have specialized units which handle country risks. These units set and control the degree of exposure that a bank will be willing to take in each country it deals with. This system of policing is essential in order to ensure the stability of the bank in the face of the temptation for operational staff to enter into more profitable transactions despite higher risks. Many of the bankers dealing with the actual trade financing, of course, feel that the credit control units can be unduly strict and obstruct business opportunities.

### b. Banks' risk

All international trade transactions involve the participation of one or more foreign banks. Yet not all such banks have the same degree of stability and strength; a letter of credit issued by a reputable bank provides more security than one issued by a lesser-known bank. Among the elements that influence the rating of a bank are the following:

- Having a history of delaying or actually renegeing on payment;
- having a habit of rejecting documents with trivial discrepancies;
- being domiciled in a country notorious for foreign exchange restrictions; and
- being domiciled in a country classified as high risk.

Different risks are taken by different banks. Banks usually try to specialize in specific regions or countries. After setting up the credit limits of the countries, banks define the credit limits for the various institutions they are willing to deal with in those countries. If a local bank is very risky, they will refuse to deal with it. If the country is risky, the banks will either reduce the credit limits or increase the rates charged. There is always a margin of flexibility to deal with higher-risk countries or banks, provided that an additional guarantee can be supplied or a recourse to a better-rated third party can be obtained. Difficulties arise when dealing with a new bank; it is always difficult for newly created banks to establish correspondent banking relationships.

Banks in general try to maintain what is called "bank's relations". They have experts who visit the various countries and banks they traditionally deal with in order to keep a track record of their performance and accounts. In addition, banks maintain strong relations with the central banks of the emerging markets with which they are concerned.

## *2. Transaction risks*

When financing an import or export transaction, banks look at the safety of the transaction; i.e.



security issued by the counter-bank involved in the transaction and the risks and performance of the contracting partner.

Banks are becoming more and more sceptical in choosing their trading partners and, based on their own research and analysis, they decide whether to accept a deal and the degree of risk they are willing to take. Over the past decade, banks have become more reluctant to finance deals and are imposing greater cautions on traders.

Following are the main elements that banks will analyse in order to identify the degree of risk incorporated in a trade transaction:

a.      The financial status of the customer

Before accepting to open a letter of credit, the banks in general will conduct research on their clients, examine their financial records, ask for references from other clients, use outside references, and check the track record of the company. This is to ensure that the customer has or is likely to have enough funds to pay for the documentary credit.

Some banks will even go further and visit the premises of their prospective client to check their operations and accounts. They consider these “face to face” meetings as a useful mechanism to reduce risks and help in successfully achieving the deal.

For a new client, the bank would generally ask for a guarantee. If the company is a subsidiary of a well-known group, the bank may consider that this provides enough comfort or may ask for a guarantee from the parent company. For smaller companies the bank would normally ask for a personal guarantee (rights on a trader’s house for example) or try to split the risk, by taking goods as a security (up to 75-80%) on the loan and take the rest in fixed security. But, even in such secured loans, the bank will first verify that the client has the potential to perform. In some cases banks refuse to take any risk and therefore deal only on a fully cash basis until trust is established with the new client.

b.      The goods

The credit limit that a bank makes available for a commodity company is greatly influenced by the type of commodity (soft or hard commodity, perishableness), the market (does the commodity have a ready market) and the commodity’s price volatility. Trade finance is supposed to be self-liquidating, but it remains risky since prices of commodities usually fluctuate. Large price volatility brings large credit risks: on one side, the buyer would be tempted to breach his contract in case of a price decrease and therefore use any discrepancy in documentation as an excuse to avoid payment. On the other, the importer would have difficulties to cover his credit since the merchandise he bought has a lesser value than what it cost him. Banks will try hard to reduce these risks. Among their measures will be the insistence that the client manages his foreign exchange exposure and uses price fixation or hedging techniques (e.g. if the client is selling a commodity, the bank will make sure that the payments he will receive will cover the cost of the credit or if the client is buying a commodity, the bank will make sure that suitable insurance is available to cover the quality of the merchandise and offer a hedging technique

to cover against price fluctuations).

c. The counterparty

If a bank is issuing a letter of credit, it would try to supervise the whole process of the trade transaction and will look at both sides of the trade transaction. If a trader is buying commodities, the bank would not only check the reliability of the seller but would also check the reliability of the company to whom the trader will be selling: whether it is a reputable company, in a secure country.

If a bank is the exporter's bank, one of its important duties, is to advise the exporter on the documentary credit it receives in his favour from an overseas bank. The bank will check carefully whether the overseas bank is reliable (using almanacs or other bank databases). In some cases the issuing bank will choose the business channel through which it is willing to deal (i.e., confirming or advising banks).

Many exporters submit documents to their bank and request that the bank negotiate the documents by giving value, i.e. they want the bank to pay for the documents prior to reimbursement by the issuing bank. In addition to the country risk and bank risk evaluation, the negotiating bank wants to be sure of the integrity and competence of the issuing bank and its ability to pay on time, since it can be very difficult to deal with banks who have the habit of complicating the procedures of the transaction or of rejecting documents (even for trivial discrepancies) and consequently delaying payments. If the issuing bank refuses to pay and the buyer refuses to accept the documents, then the negotiating bank may get reimbursed from the exporter depending on whether it has recourse or not. In case the negotiating bank has recourse to the exporter for reimbursement, it can still be very difficult to get the funds back since the exporter may have already used the funds for other trading activities.<sup>12</sup> However, if the negotiating bank is at the same time the confirming bank, then the negotiating bank will take on the liabilities and responsibilities of the issuing bank and therefore has no recourse to the exporter for reimbursement.

It is very important for a commodity firm to select carefully the bank that it wants to do business with. Its selection criteria should include:

- the bank's regional, country and commodity specializations (if, for example, sales to Asia are significant for an African exporter, it might be preferable for him to select a bank with a good presence, or good corresponding relations, in Asia);
- the bank's "track record" in commodity finance. The number of banks which are rather active in international commodity trade finance varies from year to year showing, in effect, a business cycle: margins are high, so banks start to become active in commodity finance; because of

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<sup>12</sup> If the issuing bank refuses to pay because of discrepancies neglected by the negotiating bank, the negotiating bank has no recourse at all to the seller since it was the bank's responsibility to properly check the documents before advancing payment.

increased competition, margins decrease, while at the same time some of these banks do not have the skills to manage commodity trade finance properly; and then, after some (at times quite large) losses in commodity trade finance, many banks decide to close down the relevant departments, or to concentrate on their oldest or largest clients; so competition declines, margins again increase, and the cycle can start again. In particular for a fairly new, small- to medium-sized producer or trader it can be disastrous to fall victim to this cycle; that is, to become a client of a bank which does not really understand commodity business. The producers would likely be forced to move to another bank within a few years, through no fault of their own and in the meantime, the banks do not really know how to cope with commodity market shocks (cutting credit lines at the first signs of a bad market, for example). Commodity firms should choose a bank with expertise in its commodity business, and which shows the signs of wishing to remain in this business - in the end, this may mean there are only a handful of potentially "good" banking counterparts;

- the relation between costs and service. Fees (bank charges) and even interest rates can be negotiated, and vary widely from bank to bank; but commodity firms should also understand that, in many cases, there is a wide range of possible financing methods (including pre-export finance based on letters of credit; warehouse receipt finance; factoring and forfeiting; and various forms of structured finance), and it may be worthwhile to have a full choice out of these options. Not all banks may be able to offer such a range of choices.

## **B. The importance of the bank's role in documentary credit**

- ◆ *Advising the creditworthiness of buyers and/or suppliers and giving advice on dealing with foreign markets*
- ◆ *Providing information on various financing tools and various forms of guarantee.*
- ◆ *Arranging letters of credit and transferring funds.*
- ◆ *Providing guidance in the preparation of the documents.*
- ◆ *Arranging foreign exchange transactions.*

The role that banks play in documentary credits is very important; it basically implies assisting their clients in minimizing the risks in trade and settlement mechanisms.

- At the outset, traders need to have a good knowledge of the other contracting party. This is very important to the success of any trade transaction. The role of the bank at this level is, firstly, to identify their client's/buyer's financial ability, integrity and reputation. The bank should also identify the banking facilities available to the client/buyer since this will influence the choice of payment and the financial cost involved, and will set the credit risk the exporter will have to assume. On the other hand, small traders who indeed are facing most of the risks may require some assistance from their bank in screening and identifying their partners reliability. Thus,

information can be obtained via local chambers of commerce of the country concerned, specialist companies such as Dun and Bradstreet (for large, public companies), bank references (for smaller companies), or trade/commodity associations (membership in a trade/commodity association is a good indication of a company's standing in a market as some associations may suspend members who have made any unlawful practices), and even large trading companies who know the market very well and are willing to provide relevant information. If the reliability of the buyer is not very clear then a guarantee should be provided. For example, if the buyer is a company which is part of a large group and the financial stability of the company is not clear, the seller should require a guarantee from the parent company to support its subsidiary's contract (since the parent company, in most of the cases, has no legal responsibility for either the contracts or the payments under those contracts). Most banks involved in trade have extensive networks of correspondent banks overseas, which can be helpful in gathering information on a particular country or company.

- The bank involved in opening letters of credit should play an active role in advising their clients on necessary precautions. It has been pointed out several times that traders of goods do not take sufficient precautions in international sales transactions to avoid being the victims of fraud. Therefore, banks can play a major role in highlighting the dangers involved in international sales transactions and in giving advice on how to avoid them, along with the protection possibilities available.
- Banks have a very important advisory role towards their clients. They advise their clients on the wording of the contract, establishment of a letter of credit (letters of credit are in some cases not known by traders), highlight where there might be a concern for them or for their client. A key element that the bank may advise on is the documentary requirements that come with a letter of credit. These documents should be limited to what is necessary for the proper conclusion of the deal. There are levels of documentation that complicate the transaction rather than securing payment for the transaction.
- An exporter's bank thus advises the exporter on the workability of a letter of credit: will the exporter be able to comply with its terms and conditions. This is called checking the workability of a documentary credit, and very often exporters discover that they cannot produce a compliant set of documents under a proposed documentary credit. If the bank did not undertake such a proper check, amendments would be needed which in turn will lead to additional costs and delays in payment, which small traders may not be able to afford.
- Letters of credit are generally reviewed by all banks according to the rules set out by the International Chamber of Commerce Uniform Customs and Practices Publication 500 (UCP 500). While banks differ in response time, accessibility and service, they are essentially uniform in their review of letter of credit documents for payment. However, different banks have different interpretations on the meaning of the rules. Banks who are actively involved with trading are more informed about the rules and can interpret them differently. Certain banks are capable of checking the documents in an appropriate manner, others will follow word by word what is written and will reject documents for any discrepancy, even those which are not

detrimental. Such banks can be very rigid and severe, and would not accept any divergence, specially when dealing with new customers. Some banks can even raise the divergences in favour of their customer, especially if the prices of the market are falling.

- It is important to note once again that the banks' role is to deal only with documents, they are not obliged to go beyond that. Only the wording of the letter of credit is binding on the bank; the bank is there to check every document within the validity of the letter of credit. Under the UCP, banks are not responsible for verifying the authenticity of the documents, nor for the quality or quantity of the goods being shipped. Some banks have gone beyond this rule and have gained sufficient expertise to deal with difficult issues. Some banks will not refrain from making further inquiries to check the credibility of any party involved in the transaction. In most fraudulent cases, there have been hints and indications that should have made banks suspicious of fraudulent behavior, but because banks deal only with documents, they would not accept going beyond documents and would fail to exercise proper supervision. If a bank is suspicious or the client asks for more vigilance, the bank may conduct further inquiries, checking for the shipment through IMB (International Maritime Bureau), Lloyd's, or checking with the inspection company about the quality of the shipment. However, it should be noted that any inquiries should be made before concluding a transaction since a proof of fraud is needed to stop payments, otherwise the bank is obliged to pay. For example, an issuing bank in Hong Kong was advised by its client that there was a fraud in the transaction but the bank had to accept the documents and initiate the payment process as stipulated in the letter of credit because there was no proof of fraud. Without proof of fraud in the transaction, the bank had to pay the exporter because the proper documents were delivered. The only redress that is available to the importer is if he can conclusively prove fraud and get the courts to issue an injunction restraining the bank from making payment. Nevertheless, even if a bank can provide assistance in making inquiries, it is still the buyer's responsibility to make all necessary inquiries before entering into an agreement and, if there are any doubts, the buyer may ask his bank to make further inquiries. The documents under a letter of credit reflect all that is known about the trade transaction. When a trader is not sure about an element he may ask his bank to be more vigilant.

**Box 9**

- Very important are the guarantees that a bank provides, specifically through the confirmation of a letter of credit. When a bank gives the seller a confirmation on a letter of credit, it implies that the confirming bank will be assuming the credit risk of the issuing bank as well as the political and transfer risks of the buyer's country. The confirming bank will be guaranteeing (in addition to the issuing bank) the payment process. Confirmation, although highly recommended,

**Risks in confirmation**

- ***If the issuing bank refuses to pay.*** When the confirming bank pays the client and the issuing bank refuses to pay, then the confirming bank will assess whether the alleged discrepancies advised by the issuing bank are relevant or not. If the discrepancies are evident, then the confirming bank will accept the error, otherwise it will try to negotiate or, as a last option, go to court.
- ***If the issuing bank goes bankrupt:*** The confirming bank usually has facilities and limits for countries and banks within those countries. They are willing to take the risks on certain banks and if an issuing bank goes bankrupt the confirming bank will have to take the loss.

can sometimes be difficult to get. Some countries, in accordance with their policies, do not allow most of their credits to be confirmed (notably China). In other cases, the buyer's credit arrangements with his issuing bank may not allow the buyer to make a confirmation request. A bank would not add confirmation to a credit unless it has a credit facility or collateral to cover the 'country risks' and the 'transaction risk' related to the confirmation. Confirmation by a bank ties up the credit line of the confirming bank with the issuing bank until the reimbursement is made to the confirming bank. Therefore, an issuing bank may refuse to accept any confirmation request. In such circumstances the possibility of "silent confirmation" of the credit exist without the issuing bank's knowledge. Silent confirmation is outside the jurisdiction of UCP 500 (according to the UCP500 Article 9(b); a confirming bank should be either requested or authorized by the issuing bank to add confirmation). Silent confirmation represents a purely private and mutual agreement between the beneficiary (the seller) and his bank. The rights and obligations of both parties are governed by the terms and conditions of a solid bond contract.

- Banks can also advise their clients whether to confirm a letter of credit issued in their favour and provide information (information related to the risk involved to the transaction and the additional cost of confirmation) that will enable their client to make a decision. For instance, the opening bank may be so strong that confirmation adds nothing, or confirmation costs which may be paid only by the beneficiary up front can be substantial and cannot be covered by the beneficiary.

BOX 10

**Other types of bank guarantees as instruments  
for securing performance or payment**

Parties involved in international trade may request additional guarantees in relation to their underlying contractual relation. The buyer would require a bank guarantee that will secure the seller's ability to perform adequately. On the other hand, the seller may require a bank guarantee that will secure the buyer's ability to pay.

**What is a bank guarantee?**

"A bank guarantee may be defined as the irrevocable obligation of a bank to pay a sum of money in the event of non-performance of a contract by a third party. The guarantee is a separate obligation independent of the principal debt or the contractual relationship between the creditor and the principal debtor. Under the terms of the guarantee the bank has to pay on first demand provided that the conditions contained in the guarantee are fulfilled. Guarantees are, as a rule, subject to the laws of the country of the issuing bank."

ICC has issued two publications on guarantees; "Uniform Rules for Demand Guarantees (Publication no. 458) and "Uniform Rules for contract bonds" (Publication no. 524).

Source: *Guide to documentary transactions in foreign trade*, UBS, Switzerland, 2nd Edition, January 1995.

Following are the principal types of guarantee used in international trade:

**1. Bid Bond ( or Tender guarantee)**

This guarantee is required in connection with public tender. If a company is participating in a tender, it must submit along with its offer a bid bond (the bid bond would be for 1-5% of the amount of the offer). The purpose of the tender bond is to provide the beneficiary with a guarantee (compensation) if:

- the bidder withdraws his offer before adjudication (expiry date),
- the bidder refuses the contract after its award to him,
- the bid bond, after the contract has been awarded, is not replaced by a performance bond.

**2. Performance Bond**

This guarantee is provided by the bank, at the request of the seller/contractor, to pay the beneficiary (buyer/contracting party) the guaranteed amount (5-10% of the value of the contract) in the event the seller fails to fulfill in part or in full, his obligations under the contract (e.g. a performance bond may be used for securing the performance in a trade operation for delivery of a product). Performance bonds are generally callable by a simple claim by the beneficiary, who is thus not obliged to show any proof of performance under the contract.

**3. Advance payment guarantee (letter of indemnity)**

In some export transactions, the buyer may be required to pay the seller an instalment (to finance the transaction, cover cost of production, raw materials, etc.) prior to the seller's performance under a contract. However, the buyer would request an advance payment guarantee to ensure repayment of the sum advanced by him to the seller, in case the latter fails to fulfill, in part or in full, his contractual obligations.

**4. Payment guarantee in case of non-payment**

This guarantee is provided by the bank basically to provide security of payments on an "open account" basis but it can also be used for other purposes. For instance, it can be used as a security for the full payment of the delivery of goods, in case the seller delivers the goods but does not receive payment at maturity.

**5. Standby letter of credit**

The standby letter of credit performs a similar function to a bank guarantee but operates on letter of credit principles, except that it allows the beneficiary/seller in a letter of credit to be paid in the event of default by the applicant/buyer. It therefore does not constitute a means of payment but a guarantee of indemnity in case of non-performance of the contract by the exporter. Standby's are often used to guarantee payments on trade purchases (i.e. securing the payment for the goods delivered by third parties, performance under government contracts, performance of construction contracts.

Typically, in a trade transaction the seller may be willing to ship on "open account" basis as long as a standby letter of credit is issued to the seller in case the buyer defaults on his contractual obligations. On the other hand, the buyer may

- One guarantee that the bank requires is the Bill of lading made to the name of the bank. When banks open a letter of credit, they receive from the beneficiary the documents and the bill of lading issued to their own order, pay for the documents by drawing a loan for the client, then release the bill of lading to an acceptable warehouse and inform the warehouse operator that the commodities will be released on their order and against a trust receipt on the merchandise to be released. The bank will try to deal with reputable warehouses (for example, mentioned on the list of warehouse companies published as “London financial approved warehouse”). The possession of the documents gives the bank a real right of property to the goods. They have recourse to the goods in case the client does not pay back the loan.

**Box 11**

**Fraud under Standby letters of credit**

A standby letter of credit is in the nature of a guarantee, but operates on the principles of letters of credit, i.e. it is a promise to make payment upon presentation of the required documents. Payment under a guarantee is made on the performance of a specific ascertainable action for which payment has not been made, whereas payment under a standby letter of credit is made on the presentation of a document proving the performance of a specific ascertainable action and for which payment has not been made. The banks still deal only with documents and their main duty is to examine the compliance of the documents with the terms of the standby letter of credit. The banks would honour the credit by referring solely to the documents and the terms of the standby letter of credit. A standby letter of credit would be required in cases where the parties do not have enough confidence in each other or when the financial situation of the buyer is not very clear.

Since most payments under standby letters of credit require only a document drafted by the beneficiary, potential for frauds and disputes under standby letters of credit is therefore greater than documentary letters of credit. A fraudulent beneficiary would take advantage of the standby letter of credit by supplying a fallacious document of entitlement. The beneficiary to a standby letter of credit has the right to draw from the standby letter of credit on demand, so it is therefore the buyer who will be assuming the added risk.

➔ *One possible solution to counter such risk is to request a person or entity unrelated to the transaction to provide the required document.*



## Chapter III

### MAIN DOCUMENTS USED IN INTERNATIONAL COMMODITY TRADE

Documents are the key issue in a letter of credit transaction. Banks deal in documents, not in goods (Article 4 of UCP 500). They decide on the basis of documents alone whether payment, negotiation, or acceptance is to be effected. If proper documents are presented, banks will make payment whether or not the actual goods shipped comply with the sales contract.

Thus, special attention has to be given to the correct list of documents since a slight omission or discrepancy between required and actual documents may cause additional cost, delays and extra work for both buyer and seller and may prevent the merchandise from being exported. This can result in the exporter not getting paid, or even in the seizure of the exporter's goods by national or foreign government customs. Even before the letter of credit is issued the buyer and seller should clearly decide on the documents that are needed for the accomplishment of the sale transaction. The letter of credit should precisely state the documents required and their contents. As to the documents that accompany a letter of credit, they depend primarily on the requirements of exporter's and importer's governments. The size and composition of the documentation are greatly influenced by the nature of goods, type of transport, destination of shipment, and delivery terms. The UCP guidelines specifically describe transport documents (Articles 23-30)<sup>13</sup>, insurance documents (Articles 34-36) and commercial invoices (Article 37). As to the other documents, they are treated on a general basis only.<sup>14</sup>

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<sup>13</sup> Transport documents are documents indicating that goods have been loaded on board, dispatched, taken in charge, accepted for carriage or received for dispatch (UCP).

<sup>14</sup> Unlike the UCP 400 that was mainly concentrated on the bill of lading - with only a general reference to other transport documents, the UCP 500 now contains a different article for each type of transport document likely to be used in international trade, with a further separate article relating to freight forwarders' documents. The articles as they are laid out in UCP 500 are as follows:

Article 23 - Marine/Ocean Bill of Lading

Article 24 - Non-Negotiable Sea Waybill

Article 25 - Charter Party Bill of Lading

It should be noted that many international commodity transactions are performed by transfer of title rather than the physical delivery of the merchandise (e.g. the case of cocoa and coffee). Title to goods is hence conveyed by a set of shipping documents, one of which is the bill of lading. It is, therefore, very important to have shipping documents which conform in all respects to the sales contract established between the parties and to have the merchandise delivered on time and in good quality.

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Article 26 - Multimodal Transport Document

Article 27 - Air Transport document

Article 28 - Road, rail and Inland Waterway transport Documents

The instructions for examining each document are basically the same and broadly follow this order:

Issuer/Signor - On-Board - Date of Shipment - Intended Vessels/Ports - Set of Originals -  
'Fine Print' - Transhipment.

There are two other articles dealing with transport type documents, namely:

Article 29 - Courier/Post Receipt

Article 30 - Freight Forwarder's transport document issued as (a) carrier and (b) agent.

It is very important to fully understand the various aspects of documentation (including costs and risks) in order to avoid unnecessary delays and to ensure that the proper trading process, with the associated costs, is incorporated in the invoice price of the products shipped. Failing to get the documents, right on time, can have serious financial repercussions on the traders (several surveys have indicated that not less than 50% of documents presented are initially rejected). Not only will additional administrative costs be incurred to amend the credit or to extend its time limit but unexpected additional costs will be added to the final cost of the letter of credit transaction to cover preparation of the revised documents and to pay other interest charges for delays (such as credit insurance cover, and banks' indemnities in case of non-payment). This chapter will give a short introduction to the main documents required in international commodity trade, and which party can or should supply them. Rather than giving an extensive description of the documents themselves, the chapter will be structured around the potential risks of using the documents, pointing out common sources of discrepancies or problems.<sup>15</sup>

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<sup>15</sup> ITC (International Trade Centre UNCTAD/WTO, Geneva) has published in 1994 a *training handbook on export documentation*, which provides an extensive illustration on the preparation and the use of trade documents in the context of export operations and on which much of this section is based.

BOX 12  
**Trade Documentation**

The following is a list of documents which are most commonly used in international trade. It should be noted that the list of documents that accompany a letter of credit is built upon the requirements of both the parties, as well as the governments involved.

**Commercial invoice** - The commercial invoice is an invoice/bill for the goods from the seller to the buyer. It is a document that gives a complete description of the trade transaction, i.e. invoice number, full listing of the goods, quantities, shipping date, mode of transport, address of the shipper and buyer and the delivery and payment terms. The buyer requires the invoice to certify ownership and to initiate payment. Some governments use the commercial invoice to determine the true value of the goods when assessing customs duties.

**Bill of lading (B/L)** - B/Ls are contracts between the owner of the goods(shipper/contractor) and the transportation company. It is considered to be a receipt for the goods shipped (given to the seller by the carrier), a contract for delivery (i.e. a contract to deliver the goods as freight to the consignee), and, most importantly, a document of title to the goods. For a further description of B/Ls see box 15.

**Certificate of origin** - Some countries (particularly those subject to lower tariffs and free trade treaties) may require, for entry purposes, a signed statement certifying the origin of the goods being traded. If the buyer requires this document, he should so stipulate in his letter of credit.

**Inspection certificate** - To add security, some purchasers and countries may require a certificate of inspection attesting to the specifications of the goods shipped, usually performed by a third party.

**Packing list** - A document that lists and itemizes the merchandise contained in each package (box, crate, drum, carton, or container), and indicates the type, dimensions, and weight of the container. The packing list is used by customs and transportation companies.

**Dock receipt and warehouse receipt** - A document issued by a carrier when the seller/exporter is not responsible for moving the goods to their final destination, but only to a dock in the exporting country. These documents/receipts are issued by the domestic carrier when the goods are moved to the port of embarkation and kept with the international carrier for export. It evidences that goods have actually reached, in good condition, the specific dock/terminal. The shipping obligations are then transferred from the domestic to the international carrier once the goods reach the terminal.

**Insurance certificate** - A document certifying that goods are insured and stating the type and amount of insurance coverage provided on the goods being shipped.

**Shipper's export declaration** - The Shipper's Export Declaration is a form prepared by a shipper/exporter indicating the value, weight, destination, and other information about an export shipment. It is basically used to collect trade statistics and to control exports (reinforcing the export control laws for trading with critical countries).

**Phytosanitary (plant health) Inspection Certificate** - A document certifying that goods have passed inspection (i.e. free from pests and harmful plant diseases) and comply with the foreign quarantine import regulation.

**Export license** - A document, issued by a government agency in the exporting country, giving authorization to export certain commodities to specified countries.

**Import License** - A document, issued by a government agency in the importing country, giving authorization to import certain commodities.

## A. Commercial Invoice

The commercial invoice is one of the most important documents in the letter of credit. It is the one and only document that describes the entire transaction from the beginning to the end. The commercial invoice is necessary for both the seller and the buyer. With the commercial invoice, the seller confirms that goods have been delivered as contracted and therefore has the right to claim payment, provided that all information, payment terms, and commodity descriptions correspond exactly with the letter of credit instructions. On the other hand, the importer needs the commercial invoice for customs clearance since it is often used by customs authorities to assess duties.

Many exporters, both new or experienced, find it sometimes very difficult to prepare a commercial invoice. They have trouble in identifying the necessary information and in knowing whether a special type of invoice such as a consular invoice is required. However, there are some specific areas that should be examined to ensure that the transaction proceeds properly:

- The commercial invoice should be set up in a very complete and comprehensive manner. All information should be clearly defined. Special attention should be given to the terms of sale, as they define the responsibilities of the seller and buyer. Terms of sale should also clearly indicate the point at which the risk of loss is transferred from the seller to the buyer.
- In preparing the commercial invoice, the seller should be very conscientious, because any mistake or lack of information can lead to unnecessary extra costs and delays (for instance, an incomplete address may lead to delays in document delivery, if the delivery address is not correctly stated, or not stated at all, delivery is then consequently delayed. Moreover, if the carrier and date of shipment are not stated, difficulties and delays will occur to trace the consignment). The seller should also check with his buyer on whether particular

### Box 13

#### The functions of the commercial invoice

1. The commercial invoice acts as a bill (accounting document) provided from the seller to the buyer, giving a complete description of the goods and its price, terms and currency of the transaction, the name and addresses of seller and buyer, the buyer's purchase order number or reference number for the transaction, and the tariff classification used by the buyer's country. Separate pricing for shipping and insurance should be attached to the base price when needed, as should the country of origin of the goods.
2. The commercial invoice is the primary document used worldwide for customs identification, classification, duty/tax assessment, and final approval of entry of the goods. Accurate descriptions are important to accomplish customs clearance and assess customs duties, facilitate customs procedures for commodity control, valuation and the clearance process.
3. The commercial invoice is the document that confirms the value of goods for insurance purposes. The commercial invoice value can never be stated as a lesser value than the insured amount.

requirements are needed for tax payment on importation (e.g. a tax reference) or other information needs to be disclosed on the invoice.

- It is crucial that the information contained in the commercial invoice coincide with the instructions in the letter of credit. Therefore, a modification of the normal descriptions of the merchandise, to comply with those in the letter of credit, may be required.
- It is important that the description of the goods be clear and accurate. An accurate description of the goods will help the buyer to check the invoice and price the goods for sale, and allow the customs to clearly identify and classify the products for entry into their country. In addition, in most cases, commercial invoices are translated by the customs broker or freight forwarder for customs clearance purposes and an appropriate product identification and description must be presented to have a proper translation.
- In order to avoid delays in payment, the customer's order number should be notified on the invoice. If no number is quoted, the name of the person placing the order and the date when the order was issued should then be mentioned. This will allow the buyer to quickly identify the specific transaction.
- If the currency used for the invoice is not stated, confusion will arise and will lead to additional costs to the exporter.
- The FOB (free on board) value of the invoice should be separately mentioned in order to allow for a proper calculation of import duties and taxes, avoiding misunderstandings and extra import tax to the importer. It should be noted that different countries have different rules in calculating import duties and taxes. Therefore, it is always useful to provide useful and detailed information on the various costs in order for the customs authorities in the importing countries to set an accurate value. It is extremely important that, based on the terms of sale, all costs be separated to show specific charges for such items as: freight charges, transportation, insurance, packing etc. If, for instance, the terms of sale go beyond Ex Works (EXW), the base price of the goods must be shown with the various additional costs involved such as packing, insurance, transportation and related costs listed separately. This clearly indicates what costs are being added to bring the final price of the merchandise up to the indicated terms of sale.
- It is usually recommended that an exporter provide a minimum of three signed and dated copies of the commercial invoice; one for himself to process the shipment, one to the buyer, and one to customs officials in the importing countries.<sup>16</sup>

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<sup>16</sup> In article 37 of UCP 500 related to Commercial Invoices, it is stipulated that a commercial invoice does not have to be signed but it must, on the face of it, appear to be issued by the beneficiary (unless it relates to a transferable letter of credit).

- In many cases countries may require specialized forms of invoices (known as consular invoices) for imports into their country. A country might require a Consular Invoice to control and identify goods. In most cases the consular invoice would be purchased from the Consulate of the import country. Usually, the invoice must be prepared in the language of that country. In many cases these invoices also have to be legalized and certified by the Consulate and/or Chamber of Commerce of the country involved. If a Consular Invoice is required, it is advisable for the exporter to utilize the services of a forwarder and/or a consular service specializing in the preparation of these invoices.<sup>17</sup>

The future will bring many changes in the way international transactions are handled. There will be greater use of EDI (electronic data interchange) for exchange of documents and information. The EDI will be explained in chapter 4.

## B. Certificate of Origin

Certain countries require a signed statement to attest the origin of the goods being exported. Such certificates are completed by the exporter and can usually be obtained through a semi-official organization such as a local chamber of commerce.<sup>18</sup> The certificates of origin can also be issued by an international commodity organization. The certificate of origin often has to be legalized (endorsed) by the local chamber of commerce or by the local embassy or consulate of the country requiring the certificate of origin. If there is no representative of the importing country in the country of export, then it is necessary to send the document for endorsement to the trade authorities in the importing country, which sometimes can lead to additional delays.

<b>Box 14</b>
<b>Certificates of origin</b>
<p>Many nations take into consideration the origin of goods to take decisions on the following:</p> <ul style="list-style-type: none"> <li>• whether the goods may be legally imported into the country,</li> <li>• whether the goods are being imported from an embargoed nation,</li> <li>• whether the goods fall under a quota system,</li> <li>• whether the goods qualify for any preferential treatment under a trade agreement,</li> <li>• and what specific rate of duty applies.</li> </ul>

With the growth and development of the global marketplace, many countries have established trade relationships with specific terms and benefits. Therefore, customs officials need to know the origin of imported goods to accurately assess tariff rates and duties. Even though the commercial invoice contains the information, the certificate may be required to provide further precision as to certain requirements. It is therefore very important to have a complete and accurate certificate of origin that complies with the rules and laws of the importing country:

- The exporter should check with his buyer about the requirements in regard to the certificate of origin, i.e. if a special form is needed, if endorsement is required, the tariff reference and

<sup>17</sup> Export Observer Online, *Commercial/Consular invoices*, by Robert Imbriani, UNZ&Co, New Jersey.

<sup>18</sup> In many countries, chambers of commerce, as trade institutions, play a major role in trade facilitation by helping companies exporting to international markets and making available the documentation required by the importing country.

requirements. While there is a general certificate of origin format that is accepted by many countries worldwide, some countries may require specific certificates of origin (e.g. Nigeria, Mexico).

- In some cases, international organizations for commodities (e.g. the international coffee organization, ICO) issue a specific certificate of origin form for an international shipment. The form includes details related to identity, size, origin, destination and time of shipment. These certificates are used to control and regulate the movement of the commodities worldwide and they are also used to enforce quota limits that individual exporting countries may have agreed on. Therefore, exporters should comply with all the regulations of these specific forms.
- The name of the consignee and the consignor, their addresses, shipping details and other general information should be identical to the commercial invoice or other documents (i.e. bill of lading and packing list), otherwise the document will be rejected by the customs authorities.
- If the country of origin is stated incorrectly heavy penalties may be incurred.
- The quantity of goods being shipped should be clearly denoted in the units used in the tariff of the importing country, otherwise there may be delays in customs clearance and extra charges for import duty. On the other hand, it is very important for the description of the goods to be consistent and relevant with that covered by the tariff reference and requirements (the need to show the exact number of pieces/packages or the net and gross weight when making up the consignment).
- Certain countries accord tax or duty exemptions on certain commodities from certain countries. For example, the European Union allows shipments of coffee from ACP (African, Caribbean and Pacific) countries to enter duty free under the Lomé Convention and Finland exempts duty on coffee imports from LDCs. However, authorization for exemption of duty or tax is obtained through the submission of an official duty-exemption certificate. When a buyer is in doubt about whether such a certificate is required, he should ask his local chamber of commerce or other trade authority. Buyers may refuse shipping documents that do not include the required exemption certificate unless a bank guarantee is presented for the amount of duty payable if no exemption certificate is produced.<sup>19</sup>

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<sup>19</sup> *Commodity Handbook: Coffee - an exporter's guide*, ITC, 1992, Geneva, p.169.



### C. Inspection Certificate

Most buyers (and countries as well) would require an inspection certificate attesting to the specifications of goods shipped, usually performed by a third party. Third party inspections, if required, are conducted by specialists. Inspection certificates are often obtained from independent inspecting/testing organizations (such as SGS, Bureau Veritas, or Lloyds Registry). Depending upon the import government regulations and/or the buyer requirements, inspection may cover verification of quality and quantity, export market price, value for customs purposes, customs classification and import eligibility. The certificates delivered by inspection companies are basically of two different types:

<b>Box 15</b>
<b>Inspection certificates</b>
Inspection certificates can basically provide the following:
<ul style="list-style-type: none"><li>• Physical identification of the goods in the country of supply/export to ensure that the goods are in accordance with the description declared by the exporter.</li><li>• Verification of the contract price, ensuring that it is reasonably in line with prevailing export prices from this country of supply or, where applicable, with world market prices.</li><li>• Customs authorities with accurate data for the assessment and collection of import taxes and levies.</li><li>• Verification of the customs classification code(s) applicable to each imported item so as to allow customs to apply the correct tariff rates.</li><li>• Checking of the inspected item against any list of items subject to specific import regulations.</li></ul>
<u>Source:</u> SGS.

- Clean Report of Findings (CRF). This is a document required by the importing (sometimes, exporting) country, as some developing countries have a large part or all of their imports (exports) inspected prior to shipment in the country of origin, as to quantity, quality and price (Pre-Shipment Inspection - PSI). These PSI schemes, entrusted to international inspection agencies, have been established by the authorities for custom, fiscal or foreign exchange control purposes and are compulsory.
- Commercial certificate of Inspection, stating the quantity and quality ( any measurable quality parameter requested by the principals). These Certificates are issued by an inspection agency acting as a neutral third party assessing the actual condition of a traded cargo between a seller and a buyer. A commercial certificate of inspection is necessary to build up a long-term relation between buyers and sellers. Bad quality of goods traded can lead to loss of market share in the long run.

Inspections are important tools to reduce trade risks and avoid frauds and abuses of trade incentives. However, these inspections, if required, do have a cost, and it is therefore very important to have a proper inspection with all the necessary and required information to avoid delays and extra charges in concluding the trade transaction:

- Pre-shipment inspection is initiated by the inspection company when the latter receives notice, either from the importing country or the seller, that inspection is required. Such inspections are

rarely qualitative but in fact are required in some countries. The physical inspection is normally undertaken in the customs territory of exportation of the goods or in the exporter's premises when it is possible. Inspection of bulk cargoes is usually carried out at the time of loading. In some cases, it may be necessary for the inspection company to carry out inspections during production or certify tests at the manufacturer's premises.<sup>20</sup>

- The pre-shipment inspection will cover the verification of quality, quantity, price comparison as well as customs classification and value. Sellers need to be aware of the quality standards of the country to which they are exporting since most countries have their own quality standards, most specifically in relation to agricultural products. It is always recommended for the seller to know in advance what are the import regulations of the country to which he is exporting. It is advisable in some cases to contact the inspection company before setting up a contract in order to negotiate the choice of standards and type of specifications. If a country has very rigid and difficult standards, the inspection company could inform the importing country and recommend reference to standards which would adapt more easily to the specific product. This case has arisen with Algerian wheat standards which are difficult to adapt to the product specificity in Argentina.
- It should be noted that some associations and authorities require a strict quality control for all shipments. Unfortunately quality standards in a number of countries have been going into retrogression and this has led many buyers to insist on seeing samples of what is actually exported before purchase. For this reason, certain large inspection companies have established pre-shipment quality control offices abroad.
- Quality requirements and standards should be clearly defined in the letter of credit, all parameters must be properly mentioned. However, one should be able to specify what is really needed, too little or too much detail can lead to problems and delays. To avoid problems it is imperative to specify the standards of quality of which it is necessary to take account.
- The scope of services of the inspection company should be clearly defined, one could get the assistance of the inspection company in determining these services. The scope of services vary according to the goods being traded.
- Another important element to consider is the factor of conversion. To obtain the specific weight of a merchandise, one would need in some instances to convert from American to European measures, and this could lead sometimes to misunderstanding or misinterpretation.

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<sup>20</sup> Inspection companies do provide their clients with the necessary information on inspection procedures and import requirements of different countries. For instance, SGS has two main publications related to that issue: a general overview of *SGS pre-shipment inspection procedures* as well as a *Data Sheet for exporters* which gives the specific import requirements for different countries. Further information can be obtained through the SGS Internet Home-page, <http://www.sgsgroup.com>.

- The most secure way to control the merchandise is the door-to-door inspection (ie. follow the merchandise from the warehouse until it is loaded and again until it is unloaded). This could be very expensive but would provide the best guarantee. However, in general one would rely only on one inspection which would be done either at the loading or unloading stage. Another type of inspection is the quality claim survey which is used by exporters and importers for insurance purposes.
- Place of inspection can be set either in the country of origin (at the time of loading) or in the country of destination (at the time of unloading or at the warehouses where the imported goods are received). Perishable goods, for instance, are verified at arrival to make sure of the state of quality of the merchandise (e.g. fruits are verified at arrival). The import requirements on fruits and vegetables are very strict. In some countries like Chili for instance, SGS works directly with the packing house throughout the whole harvest period to check the quality of the product during the packing process (i.e. the index of maturity and quality control are set during packing). SGS is mandated directly by the exporter (packing house) to check the standards of its products, since the exporter knows in advance the people he is selling to, thus allowing it to know in advance the specificity required. The quality is determined during the packing process and it is a preventive means for the buyer to receive what he is really expecting.
- In the case of crude oil there is less need to accompany a cargo with a certificate. Usually a report is issued to certify the status of the cargo. Measurements are done by weighting the ship in the water and following the official standards (API). Then a report determining the quantity is issued. Quality control is nevertheless more important than quantity control since most of the disputes arise from this sector. Quality control is done in a special laboratory, commonly before loading. Sometimes it is difficult to undertake such an inspection due to lack of a laboratory or because in the terms of sales it is specified that the analysis is witnessed by a third party. In that case the inspection company witnesses the analysis and the report. Fraud in the oil trade is infrequent because the chain of trade does not allow for it as is the case in agricultural products. The way oil cargoes are traded is very transparent and problems may arise more in reference to the terms of the sales contract rather than in relation to fraud cases or false certificates. If there is any inconstancy in the terms of a sales contract, it is then preferable to check with the other contracting parties for further examinations.
- Generally, inspections are carried out at the request of the buyer as (in most commercial transactions, quality and quantity are determined "final at loading"), he is the "absent party". The nomination of the inspection company may be made by either party in agreement with the other. The degree of inspection is mainly a commercial decision that is influenced by the buyer's evaluation of the seller. It is relevant for a buyer to name an inspection company but, in any case, the exporter shall not agree to an inspection by the buyer upon receipt of the product as a condition of payment. Nevertheless, it is frequent for a buyer to ask for an inspection of the goods at the time of unloading.
- In the fruit and vegetables trade, as the condition of the goods (quality & quantity) is determined

at arrival and thus the exporter is the "absent party", the inspection certificate is, in most of the cases, issued at the request of the exporter, who wants his interests to be protected at destination.

- Governments may require a certificate of conformity of the merchandise being imported to make sure that the merchandise really exists and is in conformity with the sales contract and with the price stipulated in the contract. This method is usually used by governments for foreign exchange controls, taxes and import duties (including under or over invoicing to escape capital controls).
- It is important to verify the authenticity of the inspection certificate by calling the inspection company, in particular when one has any doubts about a particular element in the document. It is always advisable to receive the original copy of the inspection document. However, since only one original copy is available, one should always verify the authenticity of the copy received and should require a certification on the copy. The original is difficult to forge. It is usually the copy of the certificate which is forged, i.e. changes in the certificate number, adjustment of figures and payment on the fax copy received.
- Another risk of fraud is that the cargo is changed after inspection: the cargo inspected did not go into the ship.
- The cost of the pre-shipment inspection is usually borne by the Government of the importing country, but it can also be covered by the buyer since some countries require in their laws that the buyer must cover the cost of inspection. Other countries do not require an inspection certificate for certain commodities, e.g., minerals. As to the cost of the commercial inspection certificate, it can be covered by the buyer and/or the seller (the cost of inspection can be incorporated in the letter of credit).

#### **D. Packing list**

The packing list is a complementary document to the commercial invoice. It provides relevant information to the buyer, shipping line, banks and foreign customs authorities. In most cases, a packing list is specified in a letter of credit as a required document to be submitted.

A packing list notes the size, type, number of packages, and content of the shipping container and, especially, net and gross weight in pounds and kilograms; all these are essential information hence, providing it can be indispensable to the successful completion of the

<b>Box 16</b>
<b>The packing list</b>
<p>The packing list is useful:</p> <ul style="list-style-type: none"> <li>• to the carrier/shipper when deciding how to load the consignment (safety precautions).</li> <li>• to the Customs authorities in carrying out their inspection. It would provide an accurate summary of each container, thus saving time in the clearance process.</li> <li>• to the buyer in identifying the content, volume and weight of what has been shipped with reference to the original order, thus allowing to note any shortages or discrepancies.</li> </ul>

exporting process.

Even though a Packing List is not required by the customs law of every country, it is nevertheless used by some customs to check against the bill of lading or commercial invoice for inconsistencies and contradictory information. Packing lists come in various formats, all with the same basic functions: to confirm the contents of a shipment as it left the exporter's premises, and to indicate the weights, measures, number packages in that shipment and how it is carried i.e., box, cartons, etc.

When a consignment consists only of one simple product in a standard pack, it may be possible to include the packing information on the commercial invoice. However, it is always recommended to provide a separate packing list in order to have the packing information separated from financial information on the invoice.

A good packing list is not easy to prepare. One must successively number each carton, list its contents and give its net and gross weight (and for some countries, legal weights, i.e. the weight of the goods and their immediate packing). Packing information (i.e. cubic dimensions and shipping marks) and relevant data must also be properly provided:

- Before setting up the packing list, it is important for the buyer and seller to clearly understand the physical properties of the commodity being shipped, its value, and the voyage it must undergo. In packing the commodities for export, the shipper should be aware of the exigencies that exporting puts on a package and must comply with statutory requirements to ensure proper reception of all the merchandise. Four problems must be kept in mind when an export shipping pack is being designed: breakage, weight, moisture, and pilferage. Since proper packing is essential in exporting, often the buyer specifies packing requirements. For both ocean and air shipments, freight forwarders and carriers can advise on the best packaging. Marine insurance companies are also available for consultation. Finally, because transportation costs are determined by volume and weight, special reinforced and lightweight packing materials have been devised for exporting. Care in packing goods to minimize volume and weight while giving strength may well save money while ensuring that goods are properly packed.
- The packing list should state the invoice reference and the date of the invoice otherwise it may be difficult to match the documents if they are separated.
- Additional charges may occur if the total gross weight of the consignment is not clearly separated from the net weight of the consignment.
- It is essential, as well, to specifically define the content, gross weight, size and outside measurement of each container (either in cubic feet or metres). It should be stated how goods are packed and whether special handling is required. When doing so, it is also required to give each container a specific and corresponding number. This task needs to be coordinated with those who will be physically packing the goods in order to insure an accurate summary of each container, its corresponding number and, of course, specific contents.

## Box 17

### Physical shipment of merchandise

The physical condition (i.e. whether liquids, gases, or solid form), quality and quantity of a product to be shipped is one of the main components determining the choice of transportation. For instance, liquids and gases cannot be transported unless they are carried in appropriate vessels. Therefore such cargo has to be either contained in drums, flasks, tanks, etc. or be shipped in special vessels with specific structure and requirements to match the requirements of the merchandise to be shipped (e.g. perishable goods require refrigerated holds and specific liquids may require tanks with heating coils). On the other hand, the size of shipment and quality will determine whether it is more appropriate and less costly to transport the shipment as bulk cargo, break-bulk cargo, or general cargo;

- If the product is homogeneous in terms of quality, grade and other technical specifications then it can be carried in **bulk cargo** (i.e. loose form), without any packing (and transported as full or part shiploads). Large quantities of products with homogeneous characteristics constitute full cargo. Such products include crude oil, most solid minerals (coal, iron ore, manganese, bauxite, etc.), food products (rice, wheat, maize, tapioca, vegetable seeds/oils, salt, etc.) and some chemicals in solid liquid form. It should be noted that different types of cargo can be carried by the same ship where each cargo can be stocked in a different zone on the ship.
- If the merchandise to be shipped in bulk cargo is too little in relation to the space available in the bulk cargo vessel, then it is more economical to have the merchandise shipped in **break bulk** packed in drums, boxes, cases, casks, crates, etc. Break bulk refers to the process of unitizing bulk cargo to make it suitable for shipment as general cargo.
- If a variety of products with different characteristics and features is to be shipped on the same vessel then it can be carried in **general cargo**, with packing requirements. This type of shipment is generally used for most manufactured goods.

Source: *Maritime Transportation Guidelines for Importers* - Guide No.4, ITC (International Trade Centre, WTO/UNCTAD), Geneva, 1994, p. 9-10.

- An important element of the packing list that is often overlooked is the "marks and numbers". It is a shipping term that refers to the way in which the consignment is addressed and numbered. The exporter should not omit to specify the address exactly as it will appear on each shipping unit. The term "fully addressed" is used when each package is labelled with the full name and address of the consignee. As to the numbers specified in this section, they should correspond to those listed against individual items.
- The packing list should be duplicated in the language of the foreign destination.
- In addition to information, a properly prepared envelope is also a determinant in facilitating the shipment since it protects the packing list document while the cargo is in transit. As an essential element of the shipment, the envelope must be securely attached to the cargo itself. As the shipment will pass through many hands on its journey, the envelope must be such that it will remain attached and can be resealed despite handling, weather and a variety of adverse conditions.

- An accurate packing list can identify what has been damaged or is missing from a shipment and, therefore, can facilitate the insurance claims procedure. It also facilitates cargo inspection.

## **E. Insurance Certificate or Policy**

There are generally two types of loss in a sales contract: the loss that can result from damage to goods in transit, and the loss generated by non-performance of the contract.

The insurance certificate (referred to as marine cargo insurance) is a document certifying that the goods are insured for shipment and therefore covered for losses and damages during shipment. It is prepared before the shipment of the goods, and provides confirmation as to the type and amount of insurance coverage on the cargo. It is a requisite for any international trade transaction to have insurance coverage since international shipments represent a high degree of risk. Bad weather conditions, rough handling, and other common perils to shipment make marine insurance an important protection for exporters and importers. The long distance shipment, the prolonged transit time, and the transportation by more than one carrier which in turn means many loadings and unloadings, lead to extensive possibilities for goods to be easily damaged or lost. Marine insurance is therefore needed by importers, exporters and freight forwarders, to transfer risk of loss and gain protection against physical loss, damage or spoilage and delays in transit (Article 34-36 of UCP 500 relates to insurance coverage):

- Arrangements for marine insurance may be made by either the buyer or the seller, depending on the terms of sale. Further information on how to make such an arrangement can be provided by international insurance companies, freight forwarders or carriers. The undertaking of a marine cargo insurance policy or certificate, in addition to the security provided under a carrier's contract of carriage, enables a party to claim directly to the insurance company rather than to the carrier for any damages or losses. As to the carrier's liability in marine insurance, it is usually determined by international agreement. If by contract the carrier is determined to be liable, the indemnity payable by the carrier is then limited to his legal maximum liability amount. In some cases, the carrier may not even be liable at all because of the protection he can get from his legal exoneration or exceptions.
- If the terms of sale make the exporter responsible for insurance, he may either provide his own marine cargo policy or he can purchase it through his freight forwarder for a fee. This service would be useful for the occasional exporter. But, generally speaking, large exporters and importers do have their own marine cargo policies from insurance companies and it is also recommended for small exporters to have their own insurance. If the terms of sale make the foreign buyer responsible, he should provide his own policy from an insurance company or he can get it through customs brokers. In any case, the exporter should make sure that adequate insurance has been obtained. The exporter should be able to supply the necessary shipment information on time so that his buyer can take out insurance before the shipment voyage starts. If the buyer omits to obtain coverage or obtains too little, damage to the cargo would lead to significant financial loss to the exporter.

## BOX 18

### Institute Cargo Clauses "A", "B", and "C", what they cover

Most marine cargo policies use the clauses of the Institute Cargo Clauses "A" "B" and "C", which have become almost the standardised terms and conditions of insurance. Following is a summary of the risks covered under the three main types of clauses. Each is subject to listed exclusions.

#### Institute Cargo Clauses "C"

Cover loss of or damage to the subject matter insured, "reasonably attributable to":

1. Fire or explosion.
2. Vessel of craft being stranded, grounded, sunk or capsized. Overturning or derailment of land conveyance.
3. Collision or contact of vessel, craft or conveyance with any external object other than water.
4. Discharge of cargo at a port of distress.

The insurance also covers loss of or damage to the subject matter insured caused by:

1. General average sacrifice.
2. Jettison.

To sum up, the "C" clauses provide major casualty coverage during the land, air or sea transit.

#### Institute Cargo Clauses "B"

Provide all the cover that is available under the "C" clauses, but in addition cover is given for loss of or damage to the subject matter insured "reasonably attributable to":

1. Earthquake, volcanic eruption or lightning.

The insurance also covers loss of or damage to the subject matter caused by:

1. Washing overboard.
2. Entry of sea, lake or river water into the vessel, craft, hold, conveyance, container, liftvan or place of storage.
3. Total loss of any package lost overboard or dropped while loading on to or unloading from vessel or craft.

The "B" clauses provide significant additional coverage; wet damage from sea, lake or river water and accidents in loading and discharging. However, there is no coverage for theft, shortage and non-delivery.

#### Institute Cargo Clauses "A"

Provide coverage for all risks of loss or damage to cargo, except those excluded by the standard exclusions described below. The words "all risks" should be understood in the context of the "A" clause to cover "fortuitous loss", but not "loss that occurs inevitably."

General exclusions:

1. Willful misconduct of the assured.
2. Ordinary leakage, ordinary losses in weight or volume or ordinary wear and tear.
3. Insufficiency or unsuitability of packing or preparation of the subject matter insured.
4. Inherent vice or nature of the subject matter insured.
5. Delay.
6. Insolvency or financial default of carrier.
7. Deliberate damage to or deliberate destruction of the subject matter insured.
8. Loss arising from nuclear weapons.

The general exclusions are supplemented by the "Unseaworthiness and unfitness Exclusion Clause" (which excludes certain vessels from insurance coverage) and the "War & Strikes Exclusion Clause."

Institute Cargo Clauses (B) and (C) provide less comprehensive coverage than Clause (A).



- As to the cover range, one should take into account the type of cargo and the shipping route used. There are normally two primary ways to obtain cargo insurance; one is a separate insurance policy for each shipment (one time policy), the other is continuous coverage of all shipments (open insurance policy). In the latter case, the exporter does not have to prepare a separate policy: an insurance certificate or declaration is supplied to him by the insurer. At the end of each pre-determined period (usually a month), the exporter will supply the insurer with all the shipments made during that period. Among the elements that will influence the insurance coverage are the value and standard of the cargo, the packing and handling, the standards of its preparation as well as the reputation of the agent involved in its dispatch, carriage, and receipt. As to the type of insurance, although marine cargo insurance can be custom made, risk coverage can be classified in three basic risk levels with different uses of coverage level:<sup>21</sup>
  - All Risk - the broadest and most common coverage which usually excludes: delays, deterioration, loss of use and/or market (seasonal merchandise such as Christmas trees), inherent vice, strikes, riots, and civil commotion, capture, seizure and war.
  - War Risk - covered under a separate policy or by endorsement. Includes perils of war, but generally excludes delay, loss of market, and deterioration. An exception can be made in the case of air freight shipments, mail and parcel post. Coverage is in effect only while goods are Airborne or Waterborne. If the country to which goods are expedited constitutes a war risk, which is excluded from the standard coverage, then additional premiums may be required to cover political risks (delays or seizure).
  - Warehouse to Warehouse - coverage begins upon movement of goods from the shipper's warehouse and continues through the course of transit to the consignee's warehouse.
- In order to avoid delays and problems/losses in the event of a claim, the insurance certificate has to be presented in the form stipulated in the letter of credit and must contain:
  - the actual amount of insurance (the value covered should be properly calculated to make sure it covers all costs assumed by the insuring party - such as freight, inspections, and certificate of origin costs);
  - the date of issue (the date of issue must be the same as or earlier than the date of the transport document - i.e. the date of loading on board or dispatch or taking in charge of the goods; a later date of issue is acceptable only if it is expressly stated in the letter of credit - UCP, Article 34e);
  - the currency used (unless otherwise stipulated in the letter of credit itself, insurance

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<sup>21</sup> *Marine Air Land International Services*, <http://www.marineairland.com>.

coverage must be in the same currency as the letter of credit - UCP, Article 34f);

- proper description and commercial value of insured goods (the goods description must be consistent with what is stipulated in the credit and on the invoice);
  - correct marks and numbers (i.e. as described in the documents - packing list - related to the shipment);
  - name of vessel or flight details;
  - full description of the voyage covered by the insurance (i.e. the place where insurance is to start - the seller's warehouse or port/airport of loading - and the place where insurance ceases - port/airport of discharge or buyer's warehouse),
  - name and address of the beneficiary;
  - name of the agent who would be authorized to settle the claims and whose name is supplied by the insurance company and place where claims are payable.
- The insurance policy should cover transshipment in case transshipment is part of the trade transaction.
- Insurance documents must be in the form stipulated in the credit and be issued and signed by an insurance company, an underwriter, or its agent. Unless otherwise stipulated in the credit, the insurance cover must be expressed in the same currency as the credit and must cover at least the CIF or CIP value of the goods plus 10%. If, on the basis of the documents, this minimum value cannot be determined, the basis for the amount will be the gross amount of the commercial invoice or the amount to be paid under the letter of credit, whichever is greater (UCP, Article 34).<sup>22</sup> For example, when bankers cannot determine the CIP or CIF values from the documents presented against a letter of credit, they will accept insurance at 110% of the amount to be paid under the letter of credit, or 110% of the gross amount of the commercial invoice, whichever is greater.
- Similar to the bill of lading, the insurance document is normally issued in a “negotiable form” which means that the party in whose favour the document has been issued (usually the seller but it may be the seller's agent) must endorse it “in blank”. Some documentary credits require the endorsement to be made to the order of a named party (typically the buyer or the issuing bank). Claims under the policy can only be submitted by a party in whose favour the document has

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<sup>22</sup> *Guide to documentary transactions in foreign trade, Documentary credits, Documentary collections, Bank guarantees*, UBS, 2nd edition, 1995, p. 34.

been issued or endorsed.<sup>23</sup>

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<sup>23</sup> *Documentary credits*, HSBC trade Services, issued by Midland bank plc., 1996, p. 42.

**NOTES:** While damage or loss may be fully or partly covered by the insurance coverage, the contractual obligations of the seller to deliver the right merchandise on time at the right place, and the obligation of the buyer to accept the delivered goods, remain vital and enforceable.

The seller should not rely on the shipment insurance to get coverage for work not properly done (poor packing for example can lead to spoilage of goods). At the buyer's end, the buyer may be reimbursed under shipment insurance but he will end up with a product of poor quality which may be very difficult to re-sell (if the buyer is buying under an FOB or FCA, he is obliged to pay upon proper presentation of the required documents, and then can turn to the insurance company to claim reimbursement). On the other hand, the buyer may refuse to accept the damaged (or late) shipment and refuse to pay the agreed price. This would be a reason for the buyer to sue the seller and claim indemnities for an amount beyond the value of any damaged or lost goods.

There is often no point in replacing a lost or damaged shipment by a new one if the buyer is no longer interested. A classic example of this is lost or damaged shipments of Christmas trees or Christmas turkeys, which can be replaced only if a second shipment is guaranteed to arrive well before Christmas day. There are many other similar cases where either the seller no longer has an interest in replacing a lost shipment of the same quantity, quality and price, or the buyer no longer has an interest in receiving it. And even if the buyer still wants to replace a shipment, the seller may suffer a loss because, in turn, he may not be able to meet his contractual obligations, or the buyer may have to suffer a loss or additional production costs if the lost or delayed shipment he was expecting is of raw materials for production.

## **F. Bill of Lading**

The bill of lading is one of the most important documents in international trade in relation to shipment. It is a document that conveys title to goods, and proves that goods are loaded on board the vessel, complying with all conditions and packing for shipment.

The Bill of Lading has three basic functions: *an evidence of the contract of carriage* (i.e. contract between the carrier and the shipper for the transportation of the goods), *a receipt* issued by the carrier to a shipper for goods received for transportation, (i.e. a proof of delivery of the goods on board the vessel) and most importantly, *evidence of title* to the goods (the bill of lading, representing the physical cargo, proves ownership of the goods in case of dispute and when transferring rights to the goods in transit by the transfer of the paper document to another party).

The bill of lading has to be prepared exactly in accordance to what has been said in the letter of credit. Once this is achieved and shipment is made, the seller can turn to the negotiating bank with the bill of lading and all the necessary documents for payment. If everything is correct payment can be made. The bill of lading is then endorsed, conveying title of goods, and forwarded to the consignee, who can take delivery of the shipment.

**BOX 19**  
**Major types of bills of lading**

➤ A bill of lading is a receipt for the goods. The major types are:

◆ **Straight (non-negotiable) Bill of Lading:** Provides for delivery of goods to the person named in the bill of lading which is usually the consignee (buyer/importer) who needs only to identify himself to claim the goods (the shipper will deliver the goods to the consignee). The document itself does not give title to the goods. It is often used when the goods have been paid for in advance (open accounts). A straight bill of lading has to be marked "non-negotiable".

◆ **Order (negotiable or "shippers order") Bill of Lading:** This document gives title to goods. A shipper's order bill of lading can be bought, sold, or traded while goods are in transit and is used for many types of financing transactions. It provides delivery of goods to the person named in the bill of lading. It must therefore be in the hands of the consignee in order for him to take possession of the goods being shipped. Because this bill of lading is negotiable, it is usually made out "to the order of". A shipper's order bill of lading usually applies for shipment against a letter of credit to ensure proper payment on collection documents. It enables the bank involved in the export transaction to obtain title to the goods if the buyer defaults. The bank does not transfer title to the goods to the buyer until payment is received. The bank does not transfer payment to the exporter until the conditions of the L/C have been complied with.

◆ **Air Waybill:** A bill of lading issued for air shipment of goods, which is always made out in straight non-negotiable form. It serves as a receipt for the shipper and needs to be made out to someone who can take possession of the goods upon arrival - without waiting for other documents to arrive. Once the shipment commences, the exporter/shipper and the bank lose title to the goods.

◆ **Overland/Inland Bill of Lading:** Similar to an Air Waybill, except that it is used in ground or water transport.

◆ **Sea Waybill:** A non-negotiable document that allows the consignee to claim the goods directly from terminal, overcoming the delays of waiting for the bill of lading to get signed.

◆ **Through Bill of Lading:** This document is basically used for multimodal transportation (i.e. a single bill of lading used for two or more modes of transportation), where the multimodal carrier assumes the responsibility for the entire shipping movement of the cargo, i.e. from factory to final destination.

➤ Bills of lading do not necessarily signify that goods are actually loaded on a ship (or plane, or train); in effect, most of the above bills of lading come in different forms:\*

***Shipped on board***

A "shipped on board" bill of lading is a receipt that is signed and dated by the master or carrier evidencing that the goods are loaded on board or shipped on a named vessel.

***Received for shipment***

A "received for shipment" bill of lading is simply a receipt for the goods to the shipping company. To be acceptable under a documentary credit, this type of bill of lading must bear a separate notation indicating the date that the goods were actually shipped on board the carrying vessel. If the goods were received at a different place to that required by the credit, the "on board" notation must also name the actual port of loading and the carrying vessel. The date when the goods were actually shipped on board of the carrying vessel has to be stipulated.

***Charter party***

Charter party bills of lading do not contain full conditions of carriage; these are detailed in a separate charter agreement. Bills of lading of this type are not acceptable unless specifically allowed in the credit (Article 25 of UCP500).

\* Source: *Documentary Credits*, issued by Midland Bank plc, HSBC Trade services, 1996.

The bill of lading has been adapted to serve different modes of transportation. Its latest is to be used for intermodal/multimodal transportation. However, the success of achieving a proper trade transaction can be facilitated and accelerated with a precise completion of the bill of lading, whether for ocean, air or land.<sup>24</sup>

- Bills of lading are usually required to be presented along with other documents when a letter of credit is negotiated. They must be prepared exactly in accordance with the credit or a discrepancy will occur and delay payment.
- It is important to remember that the bill of lading represents the actual goods, therefore, great care must be taken when issuing a bill of lading: they have to be issued in conformity with the Mate's receipts, i.e. showing the actual condition of the cargo (number of pieces and/or weight must be correctly indicated, and any damage to the cargo must be shown on the bill of lading).
- The bill of lading may also contain the terms of carriage (i.e. the carrier's conditions of carriage), if no charter party agreement has been signed.<sup>25</sup> If a charter party has been negotiated then the charter party would govern the terms of carriage. This is because the charter party would represent the actual contract between the shipowner and the shipper. (Box no. 22 provides further details on Charter Party Agreements). There is a convention that governs bills of lading which is the Hague rules (or the new Hamburg rules). These rules apply only to bills of lading but need to be referred to in the charter party in order to cover the bill of lading.
- Normally each shipping company provides its own blank bill of lading forms, which have to be filled in either by the shipper himself or by the forwarding agent. Bills of lading are issued in sets of two to four identical originals and when completed serve as the right document of title to the goods. However, only one holder will be given the goods at destination, depending on how the bills are made out. The number of originals in the set must appear on each document. Although only one original is needed to obtain delivery of the goods, it is recommended to have the full set of originals in order to have complete control over the goods. The bill of lading conveys ownership right to the goods, and, by consignment of the merchandise, the bill of lading can be made negotiable. This allows the holder of the bill to hold his rights on the merchandise or to transfer the title or ownership of the shipment to another party. This is possible only with ocean and inland bills of lading, air waybills cannot be negotiable and, therefore, do not serve the same

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<sup>24</sup> This section is based on "*Bills of lading: the Document that controls the shipment*", UNZ & Co, Export observer online, <http://www.unzexport.com/observer/past/billalg.html>; and *Chartering and Shipping terms*, Bes, 11th edition, Barker & Howard Ltd, London, England.

<sup>25</sup> A 'charter party' bill of lading has to be expressly specified in the letter of credit (UCP, Art 23 a vi), since the contract which it evidences does not constitute a contract of carriage for particular goods but a contract for the charter of freight space (Source: *Documentary credits - a guide to safer international trading*, Credit Suisse).

purpose (with an ocean bill of lading, it should be consigned to the order of the shipper and blank endorsed).

- If the bill is a straight bill of lading, i.e. made out to a *named consignee*, then only the consignee can take delivery of the shipment. A transfer of ownership can be made through a declaration of assignment.
  - If they are made out *to order*, then the party to whom they are endorsed with the words “delivered to...” or “to the order of..” has the right to take delivery. This type of bill can be transferred by the consignee by simple endorsement. Thus, it is important to repeat that a bill of lading has to be endorsed prior to surrender if it is payable “to the order of...”, in order to obtain merchandise.
- It is very important to clearly state the destination of the merchandise (whether it is a port of discharge, airport destination, or address for inland movements). What is written on the bill of lading will lead to the discharge destination of the goods. The accuracy of what is written on this document is very important since a mistake here would be very costly, because a cargo is very difficult and practically impossible to move once it has been discharged in a particular area. It becomes even more difficult when a cargo is stowed with other cargoes in a container for a given destination. The discharge destination should be checked very carefully, and any inconsistency must be checked prior to preparation of the document .
- The method of transportation is usually specified by the type of bill of lading that is used for the transaction. When an intermodal application is used, all the combinations and types of bill of lading that are covering the transaction (whether in land, ocean or air) should be mentioned on the forms used for export documentation.
- In order to determine the tariff and the total cost of the movement of the goods, it is very important to have a clear and accurate description of the freight (exact weight and proper measures). Any particular information which will enable the carrier to apply a tariff has to be mentioned.

**NOTES:** In recent years, bills of lading have been frequently replaced by non-negotiable documents such as “sea waybills”, “liner waybills”, “freight receipts”, etc. These documents are similar to the in land (Inland bill of lading) and air transport (Air waybill) bills of lading which have been used for many years. These non-negotiable documents are simpler to use and provide considerable ease in documentary practices. They fulfil the same functions as a bill of lading except for title to goods. If the buyer wishes to sell the goods in transit he needs to have a bill of lading. However, when the contracting parties know that the buyer does not want to sell his goods in transit, they may agree that the seller use a non-negotiable document which would facilitate the delivery procedure of the goods. When using a non-negotiable document the carrier does not need to surrender the original before delivering the cargo to a consignee; the carrier only needs to properly identify this party.

## Box 20

### What happens if the ship arrives before the documents?

There are basically three possibilities:

- 1. Wait for Bill of lading to arrive** ☞ The ship Master will not release the cargo without the bill of lading. This is an expensive solution.
- 2. Deliver the goods to a reliable warehouse** ☞ The ship Master will release the cargo to a reliable warehouse (usually in the port) until the bill of lading arrives. However this solution depends on the country's regulations because in some countries one has to provide a financial guarantee (a deposit) in order to be able to have the goods delivered to a warehouse. This is a less expensive solution compared to the first one but the consignee still has to pay for storage and all other charges. The consignee would not get the cargo until he pays all charges.
- 3. Deliver the goods against a letter of indemnity** ☞ The letter of indemnity is used to replace a bill of lading's delivery function. The letter of indemnity can be used as a means to collect the cargo from the shipowner at the port of discharge without presentation of the bill of lading. The LOI's price statement covers not only the price of the goods but also the costs and consequences to compensate for carrying out a possibly illegal act (in order to be safe, the LOI coverage can sometimes be double the value of the cargo or be even unlimited). Banks will generally issue these LOI but require a guarantee against the issuance of such a document; thus, they can cost money and tie up a trader's credit line for a long time.

**Note:** Although letters of indemnity (LOI) play an major role in facilitating international trade transactions they nevertheless encounter several problems and can be a door for fraud. The ICC IMB presented a proposal to help resolve some of the main problems associated with letters of indemnity → The ICC IMB proposes to act as a repository for original bills of lading, where the ICC IMB role will be that of agent for holder of the bill of lading (for further detail of the proposal check Annex 2).

- It is also important to mention in the description of the goods if any special requirements, exist, particularly in connection with hazardous goods. Special stowage (cool, frozen, fragile, etc.), special handling, or any other requirements should also be mentioned in the bill of lading in order to facilitate proper stowage and off loading. Packages, if any, should be numbered to assist the carrier in identifying all the merchandise. Similar to the packing list, the number of packages should be mentioned to indicate to the carrier how much merchandise is being transported and how to handle it. The bill of lading should also indicate if the freight is to be prepaid or collected upon arrival of the goods at destination.
- To sum up, the bill of lading must meet all the requirements of the letter of credit, otherwise discrepancies will occur and payment will be delayed. The document issued on behalf of the carrier should clearly state the kind and quantity of goods being shipped, the name of the shipper, the consignee, the party to be notified, the ports of loading and destination, and the name of the carrying vessel (if the place of receipt and place of delivery is different from port of loading or unloading, then it should be mentioned). The description of the goods, including weights or measures, number of bags as well as shipping marks and container numbers, must conform with those specified on the other documents. The document should also state whether freight has been paid or is payable at destination. It must be dated before the latest date for



shipment that is specified in the letter of credit. It must specify the number of originals of the bill which have been issued. Finally, the bill of lading should have the actual name of the carrier and be signed by either the carrier or a named agent signing on his behalf.

- The bill of lading should be issued by the carrier with a “Clean” indication on the bill, which means that the goods were received by the carrier in "apparent good order and condition," without damages or other irregularities. A “Foul” Bill of Lading indicates that the goods were damaged when received.

BOX 21

What is the role of a Freight Forwarder?

Shipping goods overseas involves a number of different parties as well as specific requirements for documentation, packing, labelling and insurance. Because of the many considerations involved, many traders rely on freight forwarders for coordinating the shipments and meeting these various requirements.

Because the goods are being shipped to overseas customers, the exporter must be sure to follow all shipping requirements, and ensure that the goods are

- packed correctly to ensure that they arrive in good condition;
- labelled correctly to ensure that the goods are handled properly and arrive on time and at the right place;
- documented correctly to meet both import and export government requirements; and
- insured against damage, loss, and pilferage and, in some cases, delay.

The international freight forwarder acts as an agent for the exporter in transferring cargo to the overseas destination. These forwarding agents are familiar with the national government export regulations, import/export rules and regulations of foreign countries, methods of shipping and the documents connected with foreign trade. They can guide the exporter through all of the trade transaction by providing all the necessary information and paperwork related to shipping and by selecting the most appropriate shipping mode and the most economical route. The cost for their services is a legitimate export cost that should be covered by the price charged to the buyer.

- *Before the order is ready for shipping*, a freight forwarder can assist an exporter by advising him of the freight costs, port charges, consular fees, cost of special documentation, and insurance costs as well as their handling fees, all of which help in preparing price quotations. Freight forwarders may also recommend and handle the type of export packing for best protecting the merchandise in transit; they can arrange to have consolidated container shipments. The freight forwarder's main function is to advise the shipper /exporter of the date and port of shipping, to book the required freight space with the loading broker, and to prepare the bill of lading on behalf of the shipper. They may also generate the bill of lading and any special documents required in a letter of credit (marine insurance, consular invoice, clearance, etc.)
- *When the order is ready for shipping*, the forwarding agent will make sure that the goods are alongside the ship or delivered to the carrier on time for loading and that the correct custom entries are made and all claims are paid. In addition, they can assist in choosing the appropriate vessel for shipping the goods. The freight forwarder would also review the letter of credit, commercial invoices, packing list, and other related documents to make sure that everything is in order. Once the bill of lading is completed the forwarding agent will give the full set to the loading broker for his endorsement. If freight is to be paid prior to shipment, then payment will be made at this stage. After shipment, the forwarding agent delivers all documents directly to the customer or to the paying bank.
- *Once the cargo arrives at the port of export*, the freight forwarder may also undertake the necessary arrangements with customs brokers to ensure that the goods comply with customs export documentation regulations and can help in arranging for inland transportation.

## BOX 22

### Delivery terms under a *Charter-Party Agreement*

Commodity trade is usually conducted through a Charter Party Agreement: in case of any default in the transport the parties will refer to the Charter-party.

#### ☞ What is a charter-party agreement?

A *charter-party* is a written agreement (or lease contract) between the shipowner and a person (charterer) to hire an airplane, vessel, or other means of conveyance to transport goods to one or more designated locations. The charter-party sets forth the exact conditions and requirements agreed upon by both sides.

There are two types of charter-parties: **by demise** and **not by demise**. In the first case, the shipowner places the ship at the disposal of the charterer for the period of the charter and for an agreed rate. The agreement provides for an outright leasing of the vessel to the charterer, who then is responsible for his own loading and delivery. In the other case, the not by demise charter, the shipowner agrees with the charterer to transport the charterer's goods by his master and the crew. Among other specifications, the contract usually stipulates the exact obligations of the shipowner (loading the goods, carrying the goods to a certain destination), freight rate, etc.

Charter-Parties not by demise fall into main categories: time charterers and voyage charters.

1. **Time charter:** An arrangement by which the shipowner agrees with the charterer to make

available his vessel and to render services by his master and crew to carry goods on behalf of the time charterer for a stated period, e.g. 6 months a year.

2. **Voyage charter:** An arrangement by which the shipowner puts a vessel at the disposal of the charterer for the carriage of cargo from one or more ports to a named destination(s). Depending on the quantity to be shipped and the deadweight of the ship, the voyage charter can be either single voyage charter or consecutive voyage charter.

Charter-party forms have been standardized over time, and they are very much used in commodity trading. For example there might be at least eight charter-party forms for fertilizers and about 10 for coal. These forms can be adapted and tailor-made according to particular needs. However, the use of standard charter-parties reduces problems and avoids dispute.\*

#### ☞ What happens if the shipowner delivers in a different port?

The charter party agreement has 3 parties involved, the buyer, the seller and the carrier:

- The shipowner retains the option to deliver whenever the applicant wishes.
- The buyer can choose the port of destination.
- If the destination is specified in the contract and the shipowner chooses a different place; he must get the approval of the buyer, otherwise it is a breach of the contract and the shipowner has to pay for it. The buyer can issue a claim against the carrier of the goods.

For example, if the document says Hong Kong and the merchandise is delivered in Shanghai (without any force majeure justification), the buyer and shipowner have to deal with the resultant problems. The buyer will not have the ability to claim payment back but would claim additional cost from the shipowner (i.e. cost to deliver the goods back in Hong Kong). The vessel can deviate only if the buyer or owner of the bill of lading requests it, or in case of force majeure. Otherwise the buyer has the right to request the shipowner to take it back to its right destination.

\* For further explanation, please refer to "Maritime Transportation guidelines for importers", Guide No. 4, technical paper, revised 1994, International Trade Centre UNCTAD/WTO (ITC), Geneva, p.23-27.



## Chapter IV

### ERRORS AND FRAUD, AND WAYS TO DEAL WITH THEM

With the liberalisation of markets and the deregulation of the commodity sector in most developing countries, the world trade environment has changed, with an undeniable influence on trade mechanisms and, therefore, letters of credit.

In the past, buyers and sellers outside of the developed countries were represented basically by governments. Today, with the liberalisation and privatisation of the markets new buyers, sellers and banks are emerging. New companies are created which do not have either the size or the support of governments. Counterparts are not the same and the environment is less clear, with little or no information or track records on the new players. This overall situation leads to an increase in risks and frauds in commodity trading.

Another emerging phenomenon is increased credit control. Banks in some emerging countries, such as in the Middle East, are taking back control of their lines of credit. It is, therefore, the buyer's bank who decides on every aspect of the trade transaction, which makes trading even more complicated and less secure.

All these developments emphasise the vital role that documentary credit will continue playing in international trade including, increasingly, as a form of payment security. Fear of payment delays and defaults make parties insist on letters of credit again.

In setting up a documentary credit trade transaction, the buyer wants to be sure of receiving the merchandise in the right quality and quantity; in the right time and place of delivery, and to pay as late as possible. On the other side, the seller wants to be sure of receiving exact payment of the merchandise he has exported, in the correct amount, in the right currency, and as soon as possible. As to the banks, they are bound to disburse if documents comply with the terms of the credit.

It is, however, estimated that up to 90% of documentary credits have difficulties. It is very rare to have the buyer and the seller both satisfied. Discrepancies may arise (late shipment dates, absence of requested inspection documents, improper quantity indications, etc.) and due to the number of procedures involving letters of credit, instances of fraud are likely to be unavoidable. In some instances, buyers and sellers take advantage of discrepancies in order to reject the documents and thereby avoid their obligations in case of an adverse market change (increase in prices for sellers and decrease in prices for buyers). For this reason, and as is previously explained, the documents presented must correspond exactly to those stipulated in the letter of credit, since a scrupulous examination of the documents presented as payment can reduce instances of fraud.

Misspellings of unimportant words would probably not constitute a discrepancy. Missing documents, changed shipping terms, and late presentation would most probably constitute grounds for dishonouring an obligation. The numerous discrepancies must be identified by the bank who plays the role of intermediary, which deals in documents only, and pays upon proper presentation of these

documents.

A more troublesome practice to be identified is fraud. Although documents may comply exactly with the terms of the letter of credit, the buyer may not receive what he has paid for or the seller may not be paid for what he has sold. One of the parties, may ask that the letter of credit not be honoured, alleging fraud.

The frauds range from receiving money for non-existent cargoes to the scuttling of an old vessel in order to claim insurance, from the chartering of “phantom ships” to the substitution of valuable cargoes by worthless ones. The law generally favours honouring the letter of credit unless the fraud is clear and proven beyond a reasonable doubt.

The previous chapter covered the main errors and discrepancies that can arise in documents that accompany a letter of credit and the means to avoid such problems. This chapter will concentrate on identifying the main fraudulent activities that can occur in international trade and the procedures available to avoid them. The first part of the chapter will be dealing with the different types of maritime frauds, in which documentary fraud will be greatly emphasised. The second part of the chapter will provide means available to counter such circumstances.

## Box 23

### What are the common discrepancies in letters of credit ?

#### *In relation to time*

- Credit expired
- Late shipment
- Late presentation.

#### *In relation to the documents, in general*

- Non-compatibility/inconsistency of the information in the documents (contradiction between the documents).
- Original documents not marked "original".
- Document(s) unsigned.
- Documents submitted late to the bank. (Banks will not accept documents presented to them later than 21 days after date of shipment, unless otherwise stipulated).

#### *Related to the invoice*

- Terms of shipping not clear (Incoterms).
- Issued for wrong amount, or for an amount greater than the credit value.
- Issued with terms of payment and currency not clearly stated.
- Not signed/certified/legalized (when credit calls for signed invoices).
- Omits the goods description, as detailed in the credit (different description).
- Shipping marks differ from transport documents.

#### *Related to the bill of lading*

- Does not indicate the name of the carrier.
- Does not clearly define consignee, shipper, or notifying party.
- Weights and measurements differ from other documents.
- Not signed in accordance with the requirements of UCP 500.
- B/L clauséd ("foul" B/L) showing defective goods or packaging, (e.g. "rusty", "leaking drums", etc.).
- Goods shipped on deck.

#### *Related to insurance*

- Certificate presented in lieu of a policy.
- Dated after date of shipment (coverage effective after the transport date).
- Omission (on its face) of risks covered.
- Insured value insufficient.
- Absence of endorsement.
- Certificate issued under an expired policy.
- Not issued in negotiable form.

#### *Related to certificates*

- Incorrectly titled
- Content not as called for
- Not signed.

#### *Related to the Clean Report of Findings*

- Copy of invoice omitted by inspection agency.
- Copy of invoice not authenticated

#### *Telex Advices*

- Not sent within the time scales laid down in the credit.
- Incomplete or incorrect information provided.

#### *Legalisation (Visaed)*

- Omitted or not completed for all documents (and copies) where this is a requirement.

#### *Miscellaneous documents*

- Omit to present certificate of origin as required by the letter of credit.
- Omit to sign (or seal by a Chamber of Commerce) certificate of origin.
- Packing list not conform to the importing country's requirement.
- Draft drawn on the wrong party.
- Draft drawn for the wrong amount.

#### *Other common discrepancies*

- Goods shipped by sea instead of by air (or vice versa).
  - Amount claimed exceeds the credit value.
- Partial shipment or transshipment effected when not allowed.

Source: Taken from "Documentary Credits", issued by Midland Bank plc, HSBC Trade services, 1996.





**Box 24**  
**How to resolve discrepancies**

When checking the documents, the issuing bank will check the documents against the terms of the documentary credit. If discrepancies are noted, the bank will notify the seller what they are, usually by telephone or fax, and will ask for instructions. The documents are then held at the seller's risk and disposal.

The danger is that the buyer may use the discrepancies (even non-detrimental ones) in order to delay payment, extract a price reduction or even avoid liability altogether.

If there are discrepancies in documents there are four courses of action open in order to obtain payment through the credit.

**1. Amendment of the documents**

Where documents can be amended or replaced, this should be done as quickly as possible. The correct documents should be submitted to the nominated bank within the time limit stipulated in the credit. Any alterations to documents must be signed by the person or company that issued them. If possible a clean document should be obtained.

**2. Telex for permission to pay**

If there is a small number of discrepancies or if documents cannot be amended in time, the seller can request the nominated bank to send a telex to the issuing bank seeking a waiver of the discrepancies. To speed up a response, the seller should contact the buyer directly to explain the situation.

**3. Present documents to the issuing bank**

Instructing the nominated bank to telex to the issuing bank for approval can be cost effective if discrepancies are too numerous or lengthy to describe in a telex. The documents can be sent by courier which might speed up the process. The issuing bank has up to seven banking days after reception of documents in which to decide whether or not to accept the documents and effect settlement in accordance with the credit terms. During this time the issuing bank may request instructions from the buyer, so it is advisable that the seller contacts the buyer and keeps him informed, in order to ensure faster acceptance of documents.

**4. Payment under indemnity/reserve**

The seller can ask the nominated bank if it would be prepared to pay against indemnity, either from the seller or his bank covering any possible loss or consequence in the event that documents are refused by the buyer. If the documents are rejected because of discrepancies, the indemnifier would reimburse the paying/accepting/negotiating bank for the value of the payment plus interest and any costs that may arise. This arrangement is also known as "payment under reserve" but banks usually prefer the formality of taking a specific indemnity.

The main requirements for "Payment under reserve" are that a letter of credit allow such procedure and that the discrepancies are not major ones. "Payment under reserve" works best where documents are presented to one's own bank and the seller has a banking facility for that purpose. However, indemnities are usually valid for six months, which can tie up a seller's facilities for some time and have an adverse impact on his working capital. If documents have been presented to another bank, they would probably insist on having indemnity from the seller's own bank, so the same problem arises.

Some letters of credit actually preclude the taking of indemnities or payment under reserve.

**5. Miscellaneous**

Seller's should always consider that documents might be rejected by the buyer. Therefore, a seller must take adequate actions in order to keep control over the goods. Dealing with reputable carriers is a must for reducing the threat of damage which the seller may incur in such a situation.

**Note:** *One simple way to avoid discrepancies in the shipping documents is to make a quick preview of the faxed copies of the shipping documents before presenting the original documents to the bank. However, some discrepancies may not be apparent on faxed copies of the shipping documents, such as original vs. copies, signatures and endorsement.*

**Source:** *Documentary Credits*, issued by Midland Bank plc, HSBC Trade services, 1996.

## A. International trade fraud

International trade fraud is not a new phenomenon, it is a practice that has been evolving for centuries and is still growing.

Letters of credit in international trade can be used to further fraudulent trading patterns with, for example, partners trying unlawfully to obtain payment for defective or non-existent goods. Any party involved in international trade can be a victim of fraud, whether buyers, sellers, trading companies, banks, insurers or professional companies (charterers, shipping agents, shipowners). The International Chamber of Commerce (ICC) describes maritime fraud as occurring when one of the parties involved in international trade (i.e. buyer, seller, shipowner, charterer, ship's master or crew, insurer, banker, broker or agent) succeeds, unjustly and illegally, in obtaining money or goods from another party to whom, on the face of it, he has undertaken specific trade, transport and financial obligations.<sup>26</sup>

There are different and numerous types of trade fraud that can be enumerated, however four main groupings will be discussed in this section:<sup>27</sup> (a) Documentary fraud, (b) Deviation, piracy, and theft, (c) Charter party fraud, and (d) Marine insurance fraud.

### 1. *Documentary fraud*

Documentary fraud in commodity trading occurs primarily for commodities that are in high demand. The fraudulent seller would suggest a selling price that is attractively lower than what is available on the market, while relying on persuasive documents.

Documentary fraud relates to many scenarios such as forging, alteration or general misuse of the letter of credit and/or the documents that accompany the letter of credit (i.e. bill of lading, commercial invoice, insurance certificate, certificate of origin, inspection certificate, etc.). In some cases the documents may be forged or falsified

#### **Box 25**

#### **Types of Documentary Fraud**

1. Falsified documents, the cargo being non-existent;
2. Cargo is of inferior quality or quantity;
3. Same cargo is sold to two or more parties;
4. Double bills of lading issued for the same cargo.

Source: *A profile on maritime fraud*, ICC International Maritime Bureau (IMB), August, 1982.

<sup>26</sup> *Guide to prevention of maritime fraud*, ICC, Publication 370, October 1980.

<sup>27</sup> This section is condensed from; *A profile on maritime fraud*, ICC international maritime bureau (IMB), August 1982; the *Review and analysis of possible measures to minimize the occurrence of maritime fraud and piracy*, UNCTAD, September 1983; *Maritime fraud: a commercial review*, Stelios J. Niotis, June 1985; and *Documentary fraud in shipping*, by Captain P.K. Mukundan, BIMCO (the Baltic and International Maritime Council) Bulletin, Volume 93, No. 2, 98.

after their execution, in others they may be authentic documents but with false information. One case of documentary fraud would be, for instance, when a buyer purchases a cargo that will not be loaded on board for shipment, or when a buyer purchases a non-existing cargo. The goods do not really exist on the ship, the fraudulent seller has forged the bill of lading, using either the standard forms of a well-known shipping company or a fake company. By the time the fraud is discovered, the forged documents would have been presented for payment and the buyer's letter of credit will have been executed.

**Box 26**

**The common features of documentary fraud**

In international trade transactions, documents are treated as if they were goods themselves. A documentary fraud occurs when one or more of the parties to these transactions is deprived of the goods or the purchase price.

Following are the common characteristics of documentary fraud, subject to rare exceptions:

1. Contract of sale is on CIF or C&F terms.
2. payment by means of (irrevocable) documentary credit.
3. new or untried trading partners (dealing with unknown persons).
4. shipowner and crew are usually innocent.
5. victims tend to be from developing countries (basically inexperienced buyers with no expertise in international trade).
6. victims have no recourse against the underwriters or carriers.

Source: *A profile on maritime fraud*, ICC International Maritime Bureau (IMB), August, 1982.

Another case would be the fraudulent seller shipping goods which do not have the same quality/quantity that is specified on the contract of sale. The seller may ship goods which do not correspond at all to the merchandise expected, he could even ship rubbish (for instance, ship sand instead of coffee). These discrepancies are usually difficult to detect by the carrier, especially if goods are pre-packed in containers. The discrepancy should be noted before the forged documents are presented for payment.

The bill of lading is the most important document likely to be used in documentary fraud, due to its multi-purpose appellation (i.e. document of title to the goods, evidence of the contract of carriage, receipt for the goods by the carrier). One type of forged bill of lading is the predated bill of lading. A predated bill of lading is issued principally for two reasons:<sup>28</sup>

*i. to avoid paying indemnity:* One of the most important elements in a letter of credit is the date of shipment clause which specifies that the cargo has to be shipped before the final date of

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<sup>28</sup> *Documentary fraud in shipping*, by Captain P.K. Mukundan, BIMCO (the Baltic and International Maritime Council) Bulletin, Volume 93, No. 2, 98.

### Box 27

#### What is the liability of the shipowner in case of a forged bill of lading?

- In most countries, a shipowner can certify that he is not liable, if he can prove that the goods were not loaded on board of his vessel and that the bill of lading was not issued by him or upon his authority.
- However, in some countries, a consignee who has paid for a cargo under a fraudulent bill of lading may try to recover some of the losses from the shipowner whose name figures on the forged bill of lading. If such a consignee is politically powerful, he may confiscate the vessel and, by manipulating the local legal system, he can force the shipowner to compensate for the losses in return for the vessel.
- In some jurisdictions, shipowners were found liable for FCL (Full Container Loads) cargoes regardless of the fact that the cargo was stuffed and sealed in the seller's premises and the bill of lading stating that the cargo was "said to contain". Upon arrival at the destination port, the seal was found intact, but an examination of the interior of the container showed that the goods had never been shipped.
- In case the seller has been defrauded, the shipping agent may be sued by the seller because of the delivery order he has issued for the wrongful delivery of the cargo. The best defence for the shipowner would then be to prove collusion between the buyer and the seller.

Source: *Documentary fraud in shipping*, by Capt. P.K. Mukundan, BIMCO Bulletin, Volume 93, No. 2, 98.

shipment. Therefore, in order to be able to negotiate this letter of credit and to avoid paying an indemnity, the exporter may issue a predated bill of lading which meets the timing conditions of the letter of credit.

*ii. to make a profit in the shipping price:* In respect of certain commodities (such as coffee and cocoa) a November shipment may have a higher price than a December shipment. There have been cases where a shipper may request the shipping agent to issue a bill of lading dated on the 30th of November when in fact the cargo is loaded only in December. In return for such a bill of lading the seller would make some profit and would share it with the shipowner.

Although the majority of documentary fraud within international trade relate to forging, altering or misuse of the supporting documents, there have been occasions where the actual document of credit has been falsified. An example of this type would involve a forged letter of credit prepared by the buyer. The seller in that case receives a false letter of credit (i.e. a letter of credit that does not really exist). The seller does not check with his bank about the authenticity of the credit. The fraud is discovered only after shipment is made, at the time when the bank refuses to pay on the letter of credit. In this case it is very rare to be able to get the goods back.

Documentary fraud is feasible mainly because the sale transaction relies on documents rather than goods and documents are usually negotiated once the cargo has been loaded on board. One factor in this type of fraud is a lack of precautions. Except for the inspection certificate, no additional security is observed by the buyer to protect himself from unreliable sellers. The buyer trusts the carrier in verifying the merchandise when it is loaded on the ship and trusts the carrier's signature on the bill of lading confirming that the goods have been eventually loaded for shipment. The buyer will then pay the agreed price against presentation of the documents and would have therefore paid for a shipment which will

never reach the required destination or will do so without the appropriate goods. Because of the transit time between the port of loading and the port of discharge, it would usually take a few weeks for the buyer to discern the fraud, in the mean time the proceeds of the letter of credit would have been allocated and are far beyond the reach of the buyer and the court. In some cases, brokers are commissioned to sell goods where they know in advance that the trading transaction includes fraudulent elements. If the fraud is discovered, the broker would claim his innocence and would not pay back the commission he received in advance.

Another factor in documentary fraud is the fact that sometimes goods arrive at their destination before the documents, and carriers will accept releasing the merchandise against letters of indemnity. A letter of indemnity can be used in cases in which the goods arrive at the port of destination before the original bills of lading. The issuance of the letter of indemnity allows the purchaser to take immediate delivery of the goods, thus saving himself time, additional demurrage, storage expenses, insurance costs, etc. A fraudulent buyer may take advantage of the situation by receiving the goods through the letter of indemnity and subsequently selling the bill of lading to a third party. The carrier would, in that case, be in a difficult position. Having released the goods without the bill of lading, he will have to reimburse the new buyer in possession of the bill of lading, who is expecting delivery.

Documentary fraud represents half of the cases that the International Maritime Bureau (IMB) deals with. The set of documents provided with a letter of credit is a passport to fraud. A perpetrator of fraud does not have to make a vessel sink or use any strange ways to cause fraud. By simply using the documents a defrauder is capable of conducting a fraudulent deal successfully. It is obvious that reasonable precautions must be taken by all those who are engaged in international trade. To prevent their involvement in fraud, buyers and sellers should make inquiries so as to satisfy themselves as to the standing and integrity of the parties they deal with before entering into any binding commitment. In any international trade transaction, certain minimum checks should be carried out. Additional checks are necessary when dealing for the first time with unknown parties. One should be very careful of traders with no track record in the market.

## Box 28

### Overview of the main scenarios of documentary fraud

1. Non-existent cargo on a non-existent ship.
2. Non-existent cargo on an existent ship - in this category there are two possibilities, namely the vessel named in the B/L is actually at the port of loading (or even in the vicinity), but is loading cargo for some other port, or the vessel named in the B/L is trading in another area or is undergoing repairs.
3. Sending rubbish or inferior quality of goods instead of the contracted goods.
4. The date of shipment is fraudulently altered or a false date is entered on the B/L to show that goods have been loaded within the contract period to meet documentary credit requirements.
5. The buyer may obtain delivery of the goods from the shipowner on the strength of a letter of indemnity and then sell the B/L to an innocent buyer.
6. The buyer may present a forged B/L to the carrier to obtain delivery of the cargo without payment for the goods to the bank where the original documents are being held.
7. The issue of two sets of B/L for the same cargo.
8. The use of forged/fraudulent documentary credits. In this type of fraud two possibilities exist:
  1. the seller and buyer conspire to defraud paying bank, or
  2. the seller induces the buyer into sending goods on the strength of a fraudulent documentary credit.
9. False invoicing of goods to contravene exchange control regulations, or to pay less customs duty on imports.
10. Incorrect description of goods in order to:
  1. export/import banned goods, or
  2. claim export subsidy on goods
  3. claim compensation.

Source: *A system approach to documentary maritime frauds*, by Peter Kapoor, Progress report submitted for transfer of registration from M. Phil to Ph.D., at The department of shipping and transport, Plymouth Polytechnic, June 1985.

The victims in documentary fraud would usually examine the means available for them to recover their losses, in full or in part. Their first recourse would be the insurance company, who has the right to refuse payment in circumstances where goods have never actually existed. The victims would then try to redistribute the losses by first identifying the parties who may not have taken sufficient vigilance during the transaction and have acted in a negligent manner. Among the parties who are most often faced with such litigation are banks, insurance companies, and shipowners/carriers.

## Box 29

### Documentary credit fraud: a risk for buyers and sellers

#### Documentary credit fraud: How can buyers be defrauded?

The documentary letter of credit defrauder is usually (but not always) the seller: Once the seller has identified an innocent buyer, he would propose an attractive deal and would request that the buyer open a letter of credit in his favour. Once the letter of credit is issued, the perpetrator will need to provide the backing documents to obtain payment under the letter of credit. Three main scenarios may occur:

1. *The fraudulent seller ships worthless goods to the buyer:* In this situation, the seller loads the cargo with rubbish and obtains a genuine bill of lading which would be made out on a "said to contain" basis indicating the goods that the buyer is presumably expecting to receive. This transaction would require some financial means from the fraudulent seller since in most cases he would pay for the transport of the goods to destination (and for the sub-standard goods). But in any case, the fraudulent seller will still make a substantial margin of profit in the deal.
2. *The fraudulent seller ships goods of lesser quantity or quality:* In this case as well, the fraudulent seller would obtain a genuine bill of lading and would generally pay for the transportation costs. If the fraud is discovered, the seller may be able to avoid criminal liability, and may only be held liable for breaching of the contract and for losses by the buyer in civil proceedings.
3. *The fraudulent seller ships absolutely nothing at all:* In this case the seller would forge the entire set of documents that is required in the letter of credit including the bill of lading. This type of fraud is the most used by fraudulent sellers and is the most profitable. Sometimes the perpetrator would even furnish the buyer with a performance bond in the amount of, for example, 10% of the value of the cargo to hide the fraud and still make a profit.

Once the specified documents have been obtained, the defrauder will present the forged document to his bank and obtain payment. The fraud would not normally be detected until after the ship has reached its port of destination and payment has been made.

#### Documents against payment: How can a seller be defrauded?

Under documents against payment (D/P), the seller ships a cargo and sends the required original documents to the Collecting/Negotiating Bank, which is usually in the buyer's country, for presentation against payment. The aim is that the buyer should present the documents to the carrier's agent to have the cargo unblocked.

However, in order to accelerate the procedures, the documents (basically the non-negotiable bills of lading and a copy of the invoice) are sent directly to the buyer. A fraudulent buyer would forge the original documents (i.e. based upon the non-negotiable bills of lading, the buyer would prepare an "original" bill of lading) and would present them to the shipping agent to clear the cargo. The authentic bills are still with the negotiating bank but the goods have been released against forged documents. By the time the seller realises that his documents are overdue for collection, the cargo and the buyer would have disappeared, bringing in such a case the seller to undertake an action against the carrier for wrong delivery of cargo.

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**Box 30**  
**Letters of Indemnity, uses and abuses**

In documentary credit transactions, letters of indemnity (LOI) are usually used in three main situations:

1. To enable the discharge of a cargo from the carrying vessel without presentation of the bill of lading. The LOI in that case can substitute for the bills of lading (documents of title) thus allowing the shipowner to deliver the cargo to the buyer, for example when the cargo arrives before the bill of lading.
2. To induce the vessels to discharge at a different destination than the one stated on the bill of lading.
3. To obtain payment from the buyer without the original shipping documents, particularly the original bills of lading.

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**Notes:** In practice, it is likely to have indemnities issued for both cases of “discharge” and “change of destination”, in a combined format.

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Letters of indemnity are mainly used in the oil trade, since oil cargoes can be traded up to forty times between the oil supplier and the final destination. The speed with which transactions are processed means that, even if the documents move at a normal speed between traders and their banks, they are not likely to reach the final receivers for at least six months after they have been presented for payment. On the other hand, due to the fact that oil cargoes may be sold many times while still at sea, it is quite likely that the destination shown on the bill of lading will differ from the one required by the final receiver. Therefore, the changing conditions in international trade have influenced major oil companies, as a condition of their standard terms of trade, to cause payment and delivery of oil to be made against LOIs and not the original documents.

- **The indemnity for discharge of goods in the absence of the original bill of lading** represents an undertaking by signature issued by the trader’s bank in favour of the shipowner/carrier and expiring only after submitting the original bills of lading (the LOI can be unlimited as to the amount it covers).
- **The indemnity for payment in the absence of the original bill of lading** fulfils two main functions: (a) it provides various warranties, most importantly the ones in relation to the title for the goods and to the presentation of the original shipping documents; (b) it indemnifies the receiver of the indemnity against ‘...any cost or consequence of failure to provide the original shipping documents or breach of the above warranties..’. In this case a letter of indemnity represents a written undertaking issued by a shipper, in exchange for the issue by the carrier of a “clean” bill of lading. Thus, the LOI basically indemnifies a carrier for any liability in connection with the release of goods without presentation of an original bill of lading when, in fact, the goods received were not as stated on the bill of lading.

Whilst a letter of indemnity facilitates international trade it nevertheless encounters several problems and can be a central document in a fraud:

- whereby the shipper and carrier falsify to the buyer the actual order and condition of the goods at the time of shipment and issue a clean bill of lading; an example would be where a cargo of bad quality is loaded on the ship but for which a clean bill of lading is issued by the carrier and an LOI is issued by the shipper to cover the carrier against any possible repercussions. It is a fraud on the credulous buyer who obtains a clean bill of lading and assumes the cargo to be in perfect condition; or
- whereby the shipper and carrier duplicate bills of lading to replace lost or stolen originals.

Because of the problems arising from LOIs, shipowners nowadays are under pressure to refuse LOIs and to issue bills of lading with clauses showing any damages to the cargo that have been observed. This situation puts the exporter in a difficult position since he needs a clean bill of lading to negotiate the letter of credit issued in his favour. Sometimes extremely light damages, e.g. atmospheric rust on steel, are noted by the shippers and this type of comments on bills of lading can seriously complicate the execution of the trade transaction.

In order to avoid problems and reduce risks, it is important for all of the three types of indemnity mentioned above, to consider the following main elements:

1. The indemnity to be issued by a trustworthy party which is able (financially and morally) to honour its obligations under the indemnity.
2. In case of any doubts regarding the issuer of the indemnity, a reputable first-class bank must countersign the LOI
3. The wording should be simple in order to avoid ambiguities and different interpretations.
4. The indemnity must cover at least the full value of the liability.
5. In case the LOI is used to discharge a cargo, it must then be issued in favour of the consignee that is mentioned on the B/L.

It has to be remembered that even if banks' letters of indemnity can be obtained to secure the release of the goods without presentation of the bill of lading, such letters of indemnity are expensive to the commercial party and tie up credit facilities that might be granted by the bank.

A scheme devised to prevent confusion arising from the reproduction of letters of indemnity has been formulated by the International Maritime Bureau of the International Chamber of Commerce (see Annex 2).

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## 2. *Deviation, piracy, and theft*

These types of frauds occur principally with high-value cargo, in port areas that are not under close supervision and control, during times of depressed freight markets, when a charter party is not being paid for his work, or when additional costs occur through excessive and unforeseen congestion in a port.

Deviation frauds cover essentially the theft of a cargo, when a ship changes its route to unload in a different destination port and where goods are sold for the benefit of the shipowner.

An example of deviation fraud is the phantom ship frauds which are aimed at the theft of ship-loads of cargo. They are sophisticated crimes where the perpetrator (a well-organised gang) puts in significant resources to ensure that neither the fraud nor the parties involved will be identified in any resulting investigation. They usually choose cargoes that are easily disposed of but not easily traced, such as timber, metals and minerals. Typically, the scenario works as follows:

1. Ships' names are circulated through broking channels. The names themselves do not relate to any existing vessels.
2. Eventually a desperate seller, with a imminently expiring letter of credit, will respond to these leads and the vessel is quickly chosen.
3. The syndicate operating these frauds then proceeds to obtain a provisional registry in respect of the vessel through a consulate in the region (typically, the Panamanian or Honduran consulate in the region).
4. The vessel controlled by the syndicate has the new phantom identity painted on her hull and proceeds to the port and loads the cargo. Bills of lading are issued to the anxious seller to enable him to negotiate his letter of credit.
5. The vessel sails out from the load port and proceeds to an anchorage in international waters. The syndicate now has a vessel loaded with cargo, the specifications and quantity of which they know. Through commodity brokers (typically in Hong Kong or Taipei) the cargo is re-sold to other buyers.
6. With another phantom identity, the vessel proceeds to the new discharge port and discharges the cargo to the buyers who are expecting the cargo and the vessel.

Instead of buying and selling the cargo the syndicate is stealing the cargo and then selling it. On every voyage the syndicate nets the value of the cargo less expenses. Phantom ship frauds succeed for many reasons. One of these is the ease with which temporary registration is obtained from certain flags of convenience. Frequently, ships have registration certificates of more than one country at the same time, making identity changes, even disappearance, much easier to organise. In some cases the defrauder has simply forged registry documents. Very few, if any, port authorities check the registration of a vessel with the port of registry. Another reason is that sellers, desperate to load their cargoes before the final date of shipment required in the letters of credit, make no checks as to the background

and track record of the vessels/owners. The seller of the commodity has a contractual obligation to deliver the goods to a particular place at a particular time. If he fails, he can lose the deal and the money. Therefore, the seller tries desperately and as quickly as possible to get the cargo off his hands on time. He then gets paid through the letter of credit and at the same time shifts the responsibility of delivery to the shipping company.

According to the IMB, there are five to six phantom ship frauds every year, where the goods are loaded on a named ship, the defrauder changes the name of the vessel and then disappears to sell the goods somewhere else. The monitoring of ships' movements is very important to safeguard against

### Box 31

#### An example of a "phantom ship" fraud, the case of *JAHAN*

☞ On Christmas day 1996, the vessel 'JAHAN' with 28 crew members, which was carrying a cargo of 15,000 tons of sugar bound to Iraq, was reported sunk in the south Atlantic in unexplained circumstances.

☞ In January 1997, the ship turned up in Ghana where it was seized and the crew arrested.

- On Christmas day, 600 miles off the coast of South Africa, the ship had declared by radio it was sinking. According to the messages all 28 crew members abandoned ship after the vessel began taking water. The search was called off after 11 days: JAHAN had vanished along with its crew.
- It was not clear at that time what caused the sinking because the weather was fine, and the sea calm.
- The ship, built in 1972, owned by a company in Panama, registered in Belize and managed by Seatimes Shipping of Singapore, could not be found. The ship had a Ghanaian captain and a Burmese, Indian and Bangladesh' crew.
- Later, it was discovered that the vessel had been renamed *Zalcosea II* and had diverted its original voyage plan. The ship was at the port of Tema in Ghana where its master tried to sell the \$3.5 million cargo.

The alleged perpetrators made a momentous mistake. In renaming the ship, they chose a name it had once used, *Zalcosea*. Once the *Zalcosea* was reported in Ghana, the IMB, who was making the investigation, checked the ship's records and its history to discover that the *Zalcosea II* was, in fact, the *Jahan*.

Source: *Piracy - an old profession*, Mark Monday and Gary Stubblefield; Scottsdale, AZ, Hamilton, MT, 1997, the point (Project On Insurgency, Terrorism, and Security), <http://paladin-san-francisco.com/libpirac.htm>.

deviation frauds and phantom ships. Databases such as those of BIMCO or IMB can monitor the ship's actual position or can quickly establish whether the vessel is likely to be a phantom ship.

Not all deviation frauds are premeditated. For instance, cases such as a charter party dispute where the owner does not pay the charter hire, or when additional costs and delays arise due to unforeseen congestion in port, can incite the shipowner to seize the merchandise and re-sell it in order to recoup his losses.

Piracy (including boardings, attempted boardings, hijacking, detentions, and robberies at port or at anchorage) is another fact of maritime life. One common scenario of piracy would simply be pirates stealing the cargo and/or robbing the crew (often when the victim vessel is at anchor). Estimates of the cost of piracy and maritime fraud range as high as \$16 billion a year. Pirate attacks on ships rose dramatically in 1996, rising to a record 224 incidents worldwide,<sup>29</sup> and increased further to 229 in 1997, according to the IMB annual report of piracy. More than half of the attacks occur in just six countries: Indonesia, Thailand, Brazil, the Philippines, Sri Lanka and India.

Another type of fraud which would not involve the participation of the shipowners would be that of premeditated theft and pilferage, not only in ports but while the cargo is in transit or while goods are in warehouse. This can happen whenever the goods are transported, stored and handled. Lack of security, as well as bad storage and inadequate packing, can lead to this type of fraud. It is thus very important to deal with reputable warehouses.

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<sup>29</sup> *Piracy - an old profession*, Mark Monday and Gary Stubblefield; Scottsdale, AZ, Hamilton, MT, 1997, the POINTS (Project On Insurgency, Terrorism and Security), <http://paladin-san-francisco.com/libpirac.htm>.

## Box 32

### A case study of sugar fraud

**The deal** In 1996, sugar buyers from Zaire concluded a deal for the supply of three shiploads of sugar with a dealer in Taiwan. The sugar was declared to be coming from Bangkok.

**The transaction** A letter of credit of \$7.8 million was opened.

**The fraud** Forged documents were presented against payment for non-existing merchandise. The fraudulent dealer had used the assistance of a legitimate construction company in Taiwan to cover the deal.

#### ❑ What are the grounds for fraud in this case?

The case brings up the question of lack of due diligence checks from the bank's as well as from the buyer's side.

⇒ How could **the issuing bank** be persuaded to pay \$7.8 in cash when payment in the sugar trade is normally made by a bank draft?

- The bank should have known that in the sugar trade, payment against a letter of credit is usually made by bank transfer or bank draft.
- Another fact overlooked was that it is illegal to take cash out of Taiwan.

⇒ How could **the buyers** be persuaded to deal with a construction company which was known to be in financial difficulties and suddenly dealing in sugar?

- The fraudulent seller was able to procure full use of the company's address and offices, and to use the name of the company to open a bank account through which the letter of credit would arrive. The buyers should have inquired about the track record of the company.
- Another misleading fact that was overlooked is that the price offered was much lower than the market price. The sugar was bought at \$250 a tonne, when the current world price for the commodity was around \$360. With such a disparity in prices one should have been more dubious about the offer.

⇒ **The buyers as well as their banks should have contacted the IMB and requested due diligence checks to be undertaken on their behalf.**

"There are times when due diligence checks can serve no useful purpose other than to confuse the issue. And there are other times, as in this case, when fraud is so obvious that not to conduct due diligence checks is almost a crime".

Source: *More diligence needed to thwart growth in sugar fraud*, Commercial Crime International, August 1996, p.5.

### 3. Charter party fraud

Charter party fraud can be described as a fraudulent act on the part of the charterer of a vessel, to the detriment of the shipowner, the shipper, or both. It is the most difficult to prove.

Charter party fraud is usually in two forms: one that is committed by charterers against shipowners (e.g. non-payment of hire; and is often the case in a time charter party) and one that is committed by shipowners against charterers (e.g. levying of additional, and extortionate, freight charges; and is usually the case with a voyage charter party). In other instances, a sub-charterer may defraud the charterer, the shipowner and cargo interest.

An example of fraud committed by a charterer would be a case where the charterer receives full payment for the entire voyage from those who have placed the goods on board for shipment and later disappears, leaving the shipowner with the problem of delivering cargo for which he has not been paid freight. The charterer was able to conduct fraud because he collected full freight for shipment but paid only part of the hire to the shipowner. He issued a liner bill of lading (with freight prepaid), on behalf of the shipowner, to the shipper of the cargo without any reference to a charter party leaving, therefore, the shipowner with the obligation to deliver the cargo to its destination. By the time the second hire payment is due, the charterer has disappeared leaving, on one side, the shipowner with a cargo for which he is supposedly paid to deliver under the bill of lading but without funds to continue the voyage and, on the other side, the receiver of the cargo waiting for delivery of the cargo for which he has already paid.

Sometimes, in order to have more security, shipowners would insist on having a clause in the charter party which specifies that bills of lading will be issued on freight collect terms in order to have the possibility of a lien on the cargo for unpaid freight. But then the fraudulent charterer would simply substitute the original bills of lading with a set of forged bills of lading marked "freight prepaid", collect the freight and disappear. The fraud is discovered only when the ship reaches its port of destination.

Another example of a fraudulent charterer would be the case where companies charter vessels and offer a low-price rate to carry cargo. They collect the cargo and shipment fees, default on contract, then go into liquidation. The owner of the vessel would be left with unwanted cargo (for which he has been paid only part of the shipping), and would ask the buyer to pay again for delivery.

A case of fraud committed by a shipowner would be, for instance, where the shipowner has been paid for the freight of the entire voyage but fails to deliver. After the release of the bills of lading and reception of freight, the shipowner fails to continue the voyage, interrupting the itinerary with the pretext of a serious technical problem (e.g. engine problem). By this behaviour, the shipowner tries to extort additional freight from the cargo owner in order to be able to continue his voyage and to deliver the goods. In some cases, the shipowner may abandon the fully laden vessel to the local courts and creditors and, after auction, the new shipowner may not even have the obligation to honour the contract of carriage entered into by the previous shipowner. Therefore, the owner of the cargo will have to bear the consequences and, if prompt and positive action is taken, the cargo owner can still claim against default of the shipowner.<sup>30</sup>

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<sup>30</sup> Under clause 4.6 of the Institute Cargo Clauses, underwriters would be liable in some instance to cover

It should be noted that in any case, whether the charterer or the shipowner defaults, it is almost always the cargo owner who suffers the losses.

#### *4. Marine insurance fraud*

Marine insurance fraud can take various forms, covering both hull/ship and cargo insurance. It basically implies a fraudulent misrepresentation or non-disclosure of a material fact to the insurer concerning not only the value of the cargo but also the existence and ownership of the cargo.

Cargo insurance fraud can be defined as a fraudulent claim on an insurance company. The fraud may be defined as the insurance of a cargo in excess of its true value in order to take advantage from the insurance proceeds of a loss. Such fraud is usually limited to countries with foreign exchange control and restrictions, which use over-valued invoices in order to exchange local currencies into hard currencies.

However, marine insurance frauds do not only concern the value of the cargo but also the existence and ownership of the cargo. For instance, marine insurance fraud may take the form of scuttling (intentional sinking) of an over-insured vessel, which will allow the shipowner to benefit from hull insurance for more than what the vessel is worth. Scuttling of an over-insured or non-existent cargo, in addition to the hull claim of the vessel owner, enables the cargo owner to similarly benefit from the cargo insurance of over-insured or non-existing cargo. The insurance company has not only to prove that the ship was deliberately sunk but also that the party insured was involved in the fraud. Finding and gathering of evidence is a major problem, sometimes aggravated by legal difficulties caused by the laws of the country or countries involved.

Various forms of the above scenarios can take place. For instance, a shipowner may claim that a cargo has sunk, then sell it secretly, therefore acquiring a double benefit from the cargo and the hull insurance. It is usually difficult for the insurance company to prove fraud and stop payment in these circumstances.

The practice of arson is closely related to scuttling with the shipowner setting a fire to destroy the vessel and claim against the insurer since fire is an insured peril; it is generally extremely difficult to prove that a fire was started deliberately.

As with other cases of maritime frauds, insurers can avoid problems and reduce frauds by checking the accuracy and validity of the documents in case of any uncertainty. Gathering internationally available information on ships, ownerships, charterers and corporate history, help insurers in assessing risks and paying claims on lost ships. Marine insurers of developing countries often suffer losses from maritime crime and fraud due to inexperience and/or lack of information, specially about the manner in which trade is conducted in their country. If the company is small, the underwriter might not thoroughly check

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claims arising from a cargo owners' predicament. "Documentary fraud in shipping", by Captain P.K. Mukundan, BIMCO Bulletin, Volume 93, No. 2, 98.

the shipping documents, the antecedents of the trading parties, and thus the status of the vessels. It is also possible that the requirement of immediate notification of the loss or damage is not enforced. The underwriter may not have access to or may not make full use of the internationally available information about ships, their owner, charters, corporate history, etc. The insurer may also not be well organized or fully familiar with the intricacies of international trade. It has also been realized that the international criminal often has much experience and, in any case, the advantage of pre-planning. For example, in order to face fraud insurance problems in India, the insurance sector has introduced a system of verification through which different elements are checked before approving any insurance coverage: first, operational aspects, such as who has issued the bill of lading and on whose behalf it has been executed and the operator, charterer or owner of the vessel, are verified; secondly, financial aspects, such as the financial standing and bank report on the parties involved, are examined; and thirdly, the details of the ship, such as the year built, classification status, and whether any mandatory survey is pending, are investigated.

Vigilance is a key element to reduce fraud. Traps are more likely to be avoided if the people involved in trade are fully advised about the counterpart they are dealing with, and are dealing only with companies (banks, insurer, charterer, broker, etc.) that have a sound reputation. If fraud is suspected or has been discovered then it should be directly reported and the relevant authorities must be contacted immediately. Early discovery of fraud greatly increases the chance of protecting or successfully recovering the goods.

## **B. Means of avoiding frauds**

Fraud lives in dark corners, it cannot be eliminated but it can be avoided if anticipated and if simple procedures are followed to conduct transactions (simple documentation and few parties involved). It is the trade system that opens the way for fraud and errors. Risk of fraud can be reduced if prudence is observed and if few or no intermediaries are involved in a transaction.

Large trading companies, which have been in the business for a long time, have adapted to the situation and devised their own strategies to deal with documentary credit. Like banks, they undertake their own inquiries when they receive a letter of credit. Moreover, they generally have a credit risk committee that sets general country limits and client limits. They have people who monitor the business in the countries they deal with (they know the demand and production level of the country, their clients and to whom they are selling, as well as the people involved in shipping the goods). Large trading companies have their own network. They are very well informed and sometimes they can act as adviser to banks who are subject to open letters of credit from fraudulent sources. A fraudulent trader will use a terminology that can be identified by professionals. For example, sugar amounts and requirements for a specific country are usually known and a professional trader will have no difficulty in identifying a fraudulent trader who is proposing an attractive deal with a lower price or different characteristics that do not meet the usual specifications.

When it comes to credit, traders are not willing to take the risks. Before signing any contract, they need to know the risks and costs involved in the transaction. Generally speaking, they take the gamble on the price but make sure they get the money. Therefore, they consider documentary credit as a

secured means of receiving payment and know how to deal with it to their satisfaction.

### *1. Information - Inquiries*

Because international trade involves contracting parties from different backgrounds and countries, a trader should be able to identify the risk related to the bank, the goods, and the counterpart he is dealing with. As previously mentioned, the best protection for buyers and sellers against fraud is to make adequate inquiries to be able to satisfy themselves as to the reliability of the parties they deal with before entering into any binding engagement; a trader shall be fully aware of the integrity of his partner, i.e. a partner who is in a legitimate business, with a legitimate product.

Fraud can never be eliminated, nevertheless, it can be avoided if one can have a clear knowledge of how international trade operates and what are the due diligence measures that can be undertaken to avoid fraud. All parties dealing in international trade can be victims of fraud basically because of lack of information. In commodity trading information is the key. Furthermore, once a deal is agreed to, partners involved in a commodity trade transaction have to make strong and adequate investigations on the contracting parties (carriers, charterers, shipping agents, etc.) in order to make sure that they will do what they promised, i.e. to deliver the merchandise on time, in the right condition and at the right place.

One of the key elements in fraud prevention is accurate and timely information. There are specialist data bases which provide due diligence information in this respect including BIMCO, Lloyds Intelligence and Lloyd's list, and the ICC International Maritime Bureau (IMB). (For further details on these entities see Annex 3).

Some of the blame for the continuous increase of frauds lies with the fact that many new and inexperienced traders who know little about the market are seeking to set up deals that will make them gain a lot of money without much commitment on their own part. If they knew anything about the market and the business, it would help in a way to instantly identify the signs of fraudulent behaviour. Traders who are tempted by an attractive deal should have the due diligence to check the soundness of the transaction. In many cases, traders are not willing to face reality because they are quite thrilled by the appeal of a big and quick profit. On the other side, banks, if they have any doubts, should make inquiries to check the legitimacy of the transaction.

As a mechanism to reduce risks, big trading companies try to control all the elements in the trade

#### **Box 33**

#### **The information support provided by the *International Maritime Bureau (IMB)* and *Lloyd's Maritime Information Services***

- ★ The IMB Information Department verifies shipping documents within the time constraints faced by banks to negotiate documents under letters of credit and provides prompt information on contractual partners i.e. traders, shipping companies, shipowners and charterers.
- ★ Lloyd's Maritime Information Services provides the maritime business community with international maritime information from access to maritime databases (the six major maritime databases are: Ship characteristics, Ship ownership, Ship movements, Casualties, New construction and Charter fixtures).

Further details are given in Annex 3.



transaction (i.e. the goods, the vessel and documents) so that, at the time the goods are loaded on the vessel, they already know all about the conditioning of the goods, the vessel and the documents.

## *2. UNCTAD Minimum Standards for Shipping Agents*

In 1988, an ad hoc Intergovernmental Group requested UNCTAD to consider means of combatting all aspects of maritime fraud, including piracy. The UNCTAD secretariat, in close consultation with the organizations involved in shipping matters, prepared Minimum Standards for Shipping Agents.

These standards are not mandatory in nature and are to serve as guidelines for national authorities and professional associations in establishing their own standards.

Their objectives are:

- (a) To uphold a high standard of business ethics and professional conduct among shipping agents;
- (b) To promote a high level of professional education and experience, essential to provide efficient services;
- (c) To encourage operation of financially sound and stable shipping agents;
- (d) To contribute to combatting maritime fraud by ensuring improved services by better qualified shipping agents;
- (e) To provide guidelines for national authorities/professional associations in establishing and maintaining a sound shipping agent system.

## *3. The role of inspection companies - the example of SGS Guarantees*

As buyers and sellers increasingly have to deal with relatively unknown, often small, companies, the role of service providers which can give additional security to such transactions has become more and more vital. In particular, inspection companies have reacted to this by offering new products, such as door-to-door inspection and new types of coverage (unavailable from the traditional insurers), which can considerably reduce the risks of trade.

For example, in addition to its inspection and control service SGS, the world's largest, provides consultancy and technical assistance to commodities trade, maritime, port, commercial and market issues (contractual terms, customs of the trade) as well as warehouse management of strategic commodities.

One of the main concerns of traders is to receive the merchandise in proper quality and weight. The risk of having the goods damaged or lost can be very high and costly in commodity trading.

Therefore, in order to reduce these risks and the inconvenience that comes with it, SGS provides guarantees such as the following:

1. F.O.G (Full Outturn Guarantee): The SGS commitment is to guarantee the outturn weight of a consignment by assuming responsibility for differences in weight ascertained between the time of loading and of discharge. Under this arrangement, SGS assumes liability for the difference in weight arising during transport and handling, if it is not due to an insurable risk.
2. C.C (Comprehensive Coverage): The C.C provides the same guarantee as F.O.G plus it also covers marine insurance (with first class underwriters)
3. F.O.Q (Full Outturn Quality): Under this arrangement, SGS assumes liability for the differences in quality between the analytical results of the sampling at loading and at the discharge points.

These guarantees are particularly helpful to traders dealing in high risk locations.

#### *4. UNCTAD/ICC Rules for a Multimodal Transport Document*

The UNCTAD/ICC rules are the result of a cooperative effort between the ICC and UNCTAD, who saw the need to provide rules to avoid the multiplicity of different regimes governing multimodal transport. The rules, which are fully compatible with UCP 500, were established in 1992. The Rules are available to international trade for world-wide application. They had already been accepted as the basis of transport legislation in parts of South America and in the ASEAN countries.

There are 13 Rules governing the multimodal transport document including: applicability of the rules (where the rules apply only when they are referred to), definitions (Multimodal transport contract, multimodal transport operator, carrier, consignor, consignee, delivery, goods, etc.), evidential effect of the information contained in the multimodal transport document, responsibilities of the multimodal transport operator, liabilities of the multimodal transport operator, limitation of the multimodal transport operator, loss of the right of the multimodal transport operator to limit liability, liability of the consignor, notice of loss of or damage to the goods, time-bar (which has been set to 9 months), applicability of the rules to actions in tort, applicability of the rules to the multimodal transport operator's servants, agents and other persons employed by him, and finally the mandatory law.

It should be noted that the Rules only cover a part of customary contents of a multimodal transport document and are not a contract in themselves. Therefore, any party wishing to use the rules as a basis for his multimodal transport contract would have to add other clauses dealing with matters such as: optional stowage, routing, freight and charges, liens, both-to-blame collision, general average, jurisdiction and arbitration, and applicable law to satisfy his particular needs.

## 5. Electronic Commerce

Technology moves rapidly and is greatly influencing trade practices. Electronic commerce (EC) has changed the way of doing business. The success of the Internet and electronic mail (e-mail) are concrete examples of how electronic commerce technologies are facilitating trade. The Internet has not only encouraged competition, but it has also increased efficiency and expanded markets by reducing barriers and improving the availability and access to information in the global market place. Another important EC technology is the electronic data interchange (EDI). EDI is the exchange of structured data between computer applications using agreed rules.<sup>31</sup> A whole range of documents including orders, price lists, shipping notes, delivery instructions, customs declarations, invoices and remittance advices can be transferred in this way. EDI allows companies to bring together three activities: the access, collection and exchange of information. UN/EDIFACT, which is explained further below, is the international standard for this exchange.

### Box 34

#### Defining EDI

EDI is a tool for electronic commerce, used to interchange business information and as a support tool for improving business processes. It enables data in the form of document content to be exchanged between software applications, which are made to work together to process upcoming business transactions.

No consensus on a common definition can be found in literature, because of various implementations of EDI. EDI is varyingly defined as:

"The interprocess communication of business information in a standardized electronic form" (Kalakota/Whinston, 1996, p.333).

"Electronic Data Interchange is the computer-to-computer linkage between buyer and seller and the automatic transmission of purchase orders and invoices between the parties involved" (Emmelhainz, 1990, p.2).

"The transfer of structured data, by agreed message standards, from one computer system to another by electronic means" (Parfett, 1992, p.7).

"Electronic Data Interchange is the inter-company computer-to-computer communication of standard business transactions in a standard format that permits the receiver to perform the intended transaction" (Sokol, 1989, p.12).

It must be emphasized that EDI only specifies a format for business information. It is not concerned with the hardware, that is the technical transmission and implementation (e.g. e-mail, point-to-point connections).

Source: *The emergence of electronic commerce and electronic forms of money*, by Hans-Peter Erl, Thesis submitted at Technical University of Munich, 1996, <http://aib.wiso.tu-muenchen.de/lehre/dipl/hprl/c6.htm>.

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<sup>31</sup> While EDI deals with the exchange of structured messages such as purchase orders, invoices, delivery notes, payments, calculations, E-mail deals with unstructured types of communication such as memos, letters, notes, messages.

EDI started over two decades ago in the transport industry with the aim of reducing the paperwork which impedes the trade transaction process. EDI communicates between the computer systems of companies, banks, governments or other organizations. This allows businesses to manage the increasing avalanche of paperwork like purchase orders, confirmation notices, shipping receipts, invoices and other documents.<sup>32</sup>

Using EDI enables trading partners to exchange these documents in electronic, predetermined form and specific format. The main benefit in EDI is the reduction in time and cost of the transaction. The exchange of information occurs in basic units called messages, or transaction sets, which describe standard business documents (e.g. customer invoice). Each message on a transaction includes a set of data elements needed for that business document. These data elements will be organized into related groups (such as seller address which would be made up of data elements for street, city, state, zip code, and country) and formatted according to specific rules.

### Box 35

#### Advantages of Electronic Data Interchange

- EDI saves on clerical costs by avoiding re-entry of data and allows timely and error-free transaction information to be passed from one computer to another;
- EDI allows quicker and safer processing of invoices to bring speedy payment thus improving cash flows;
- EDI facilitates and speeds up border controls and other official interventions, such as Customs clearance of goods, at the same time, computer-oriented controls improve the efficiency of the controlling authorities; and
- as a whole, EDI is a new way of doing business in improving customer service. EDI is becoming an indispensable feature in production and trade, whether domestic or international.

Source: *Multimodal Transport Handbook for Officials and Practitioners*, UNCTAD, 1996, Geneva, p.30.

The concept of EDI has been introduced in all developed countries where a number of systems have been created, linking branches of the same company, counterparts in the same industry (e.g. banks, airlines) or small groups of operational partners (customs and freight forwarders, customs and airlines, container operators and sea carriers, etc.). Developing countries and small- to medium-sized enterprises have been slow to enter this field.<sup>33</sup>

In documentary trade, documents (relating to goods, transport and payment) are a key issue and they have to be properly prepared. With the new technologies, the current trend is to move toward decreasing the number of documents required. With the growth of Electronic Data Interchange (EDI), the role of documents is reduced and the need to prepare these documents is further diminished. Instead, information is transmitted using telecommunications. With the use of electronic transfer

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<sup>32</sup> *The emergence of electronic commerce and electronic forms of money*, by Hans-Peter Erl, Thesis submitted at Technical University of Munich, July 1996, <http://aib.wiso.tu-muenchen.de/lehre/dipl/hprl/c6.htm>.

<sup>33</sup> *Multimodal Transport Handbook for Officials and Practitioners*, UNCTAD, 1996, Geneva, p.30.

systems, companies are able to deliver documents quicker, while meeting higher standards in a more cost-effective manner.

For a sales contract of goods, EDI would facilitate the flow of information concerning the transaction but, today, would not be accepted by banks and others in the documentary trade transaction chain as documentary support/proof for payment purposes. The negotiable bill of lading is still the main document to provide title to the goods and guarantee of payment.

As to the electronic letter of credit, it will be used in accordance with the documents but it is still necessary for people to know how to check these documents. In commodity trading, it remains to be seen who will be able to afford such a system and the know-how to interpret the rules and how to look for the information required. (ICC is presently working on these electronic mailing rules).

In the early stages of EDI, different formats and codes were developed to meet the needs of different companies in different sectors and industries. In order to facilitate the flow of data universally, the need has arisen to have a common universal language which will permit trading partners around the world to exchange information irrespective of the type of system and communication used. It is evident that a concerted development of international standards is easier and less expensive than multiple conversions between various sectoral, national or regional systems.

a. UN/EDIFACT

As the number of partners using different standards has increased, the need to have a universal language has become obvious. In September 1986, EDIFACT (**E**lectronic **D**ata **I**nterchange **F**or **A**dministration, **C**ommerce and **T**ransport) was initiated under the auspices of the United Nations Economic Commission for Europe (UN/ECE) aiming to develop structured messages, in logical “family” groupings, to exchange business data.

UN/EDIFACT, the only internationally recognised standard for electronic data interchange, is comprised of a set of internationally agreed standards, directories and guidelines for the electronic interchange of structured data and, in particular, that related to trade in goods and services.

UN/EDIFACT relies on a simple principle: a single international EDI standard flexible enough to meet the needs of government and private industry. It specifies the structure to which electronic documents should conform. UN/EDIFACT is a set of principles which facilitates the electronic interchange of business data between manufacturers, exporters, wholesalers, distributors, retailers, brokers, forwarders, shippers, consignees, carriers, banks, insurers, ports, authorities, etc. It therefore replaces the usual paper documents with electronic files through uniformly built messages that follow international standards.<sup>34</sup>

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<sup>34</sup> *Multimodal Transport Handbook for Officials and Practitioners*, UNCTAD, 1996, p.31.

Updated UN/EDIFACT directories are issued every year containing messages from a wide range of economic sectors. The messages along with the rules that govern UN/EDIFACT are published in the United Nations Trade Data Interchange Directory (UNTDID). The UNTDID also includes various independent documents that are required in order to interpret, understand and use UN/EDIFACT messages. As of September 1997, 155 messages have been approved and are available for international use. The messages related to documentary credit applications were added more than three years ago to the directories. Examples of messages which are equivalent to traditional paper documents are: the documentary credit application message, documentary credit issuance information message, amendment of a documentary credit message, the commercial invoice message. UN/EDIFACT is currently used in over 50 countries, including all those in Europe and North America, Australia, New Zealand, China, Brazil, Colombia, Chile, South Africa, Slovenia and most Asian countries.<sup>35</sup>

The UN/EDIFACT standards, directories and guidelines were used in international trade have influenced greatly the traditional paper-based trading and facilitated the movement of cargo, and the UN is promoting its use in order to expand those benefits to more countries and parties in the trading process.

b.        Bolero

Bolero's objective is to extend practical electronic commerce to trade and to provide guaranteed and secure delivery, in electronic form, of trade documentation based on a binding legal environment and common procedures. The project is designed to replace paper documents (mainly bills of lading) by electronic documents held on a central database. It is also meant to provide a platform for the development of other future activities.

Bolero is a set of electronic rules through which diverse transport, financial, and commercial interests are put together to create electronic letters of credit. It will allow users (i.e. traders, bankers, shippers, carriers, insurers, etc.) to store and exchange electronic trade documents in a secure manner, and will provide a safe legal environment through its Rule Book (the Rule Book will provide a legal framework for exchange of electronic documentation through the provision of a set of rules which bind all users of the Bolero system). The Bolero service will be open to all forms of messages (structured electronic documents such as UN/EDIFACT and unstructured messages such as e-mail).

The paper-based documentary procedures in relation to the payment and the trade cycle of a cargo will be carried out through electronic transactions. The central repository of the project will maintain all the details of shipping documents in a computerized database. It will record changes of ownership for each cargo during its life cycle and guarantee to users that each electronic bill of lading is a valid original. At various stages in a cargo's transit, the signatures required to confirm or to transfer legal title to the goods will be transmitted electronically to the central repository. The central repository will validate and authenticate messages received. Security will be provided by digital signatures encoded through encryption keys held on smart cards. Users will also be able to exchange messages

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<sup>35</sup> Further information can be obtained through the UN/ECE Internet Home-page: <http://www.unicc.org/unece/trade/untdid/>.

directly with each other.<sup>36</sup>

Bolero focuses on the reduction of paper in electronic trade and on security aspects. The key element in this project is the bill of lading as a unique trade document. The electronic transmission of this document cuts down the number of paper copies traditionally used in the forwarding of goods, but it also has to make sure that the same transferable bill cannot be produced by two people. To guarantee that an electronic bill of lading is genuine and that each successive endorsement is valid, shippers, carriers and others will be required to use a system of encryption to encode their signature.<sup>37</sup>

The Bolero Project is sponsored by SWIFT (Society for World International Financial Telecommunications) which handles most of the electronic funds transfers for banks, and the Through Transport Mutual Assurance Association (the TT Club). This latter is a mutual insurance association, most of whose members are drawn from the multimodal transport industry or transport intermediaries and it has released a Business Requirements Specification. If this project is successful, it will facilitate documentary trade transaction and reduce problems and frauds. For instance, the data which are included in the four basic contracts used by international traders (i.e. contract of sale, contract of carriage, contract of insurance, contract of settlement) will all be inter-related and integrated. Moreover, the authentication of messages, which would be conducted through digital signatures, will allow users of Bolero not only to check electronically the authenticity of the sender but will most importantly provide "Title Registry" for goods covered by an "electronic bill of lading" and transfer title to goods to the new owner. It is obvious for the project to succeed and to contribute effectively to the trade system, that business practices and mentality have to change.

Due to the importance of data security, Bolero does rely on the Internet but uses a private network provided by SWIFT. Bolero users can access the central registry, which is kept on the SWIFT computer, using any type of PC (subscribers to the Bolero system will also require applications software and a smart card terminal). The organisation, which operates globally, consists of two companies: Bolero Services and Bolero Users (which itself comprises some 60 freight forwarders, banks, etc.). Three working parties look at the commercial, technical, and legal aspects of this particular area of electronic trade.<sup>38</sup>

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<sup>36</sup> This section is based on the article *End of the paper chase - EDI*, Project and Trade Finance, October 1994.

<sup>37</sup> The encryption key - the private key - and the circuitry to use it will be stored on the chip in the sender's smart card and entered into a PC for transmission. The sender's decryption key - the public key - will be stored on the card's magnetic stripe and will also be sent to the central repository. Data encrypted by a private key can only be decrypted by a public key.

<sup>38</sup> *Bolero*, by Ake Nilsson, European Electronic Commerce Initiatives, G8 Pilot Project "A Global Marketplace for SMEs", <http://www.ispo.cec.be/commerce/invencom.htm>.

Implementation of EDI has been slow in international trade, in part because of government constraints and lack of international standards and regulations. Bolero is not the first attempt to produce a system for electronic documents but, if this project manages to overcome all the technical constraints and the requirements of the regulatory environment applied in many countries, its application would remove the constraint of dependence on the paper-based trade



### Box 36

#### Benefits of Electronically generated documents , the example of Bolero

##### Benefits for the exporter

Electronically generated documents offer the opportunity to reduce the time between shipment and settlement for an exporter. The exporter in turn will be able to increase the quality of customer service through faster throughput of goods to buyers.

The operational costs associated with order processing, insurance, shipping and goods clearance can also be reduced. Booking information, vessel nomination, shipping advice, insurance certificates, shipping documents and clearance information are currently communicated to several parties, each one using different methods which require re-keying of the same information.

Many exporters outsource their logistics activities to freight forwarders or other transport operators. For such exporters, using electronic letters of credit will have more indirect effects. If the improvements in efficiency are not passed on to the exporter in the form of better freight rates and more accurate updates on a consignment's progress, it is possible that the Bolero Project could counteract the trend towards logistics outsourcing.

##### Benefits for the importer

Among the importer's chief objectives in using the electronic documents are to: reduce inventory days, improve the order process, improve just-in-time programmes, improve productivity and reduce direct costs.

Some of the benefits will vary by industry or geographical area. The buyer of bulk commodities, for instance in an oil shipment trading chain, will see particular benefit from Bolero use. Today, the trading of bulk commodities is handled separately from the administration of the trade documentation, partly because of the quantity of paperwork involved, but also because of the speed of trading in contrast to slow paper handling. The Bolero Service will allow closer integration and therefore a higher degree of security and accuracy between these aspects of commodity trading without any compromise of confidentiality.

Improved handling of documentary credits may be particularly important to companies in the Asia-Pacific region, where letters of credit are used as a means of obtaining working capital. Trust receipts are commonly used, whereby the importer's bank lets the importer have the B/L before having received settlement of the funds advanced under the L/C. This allows the importer to take delivery of the cargo and sell it to the ultimate customer, thus obtaining the funds to pay the bank. These practices will be made more secure for the bank and will become more precise tools for traders with the introduction of the Bolero Service.

##### Benefits for the carrier

A carrier implementing the Bolero Service can better meet customer demands for speed and accuracy in documentation and other administrative services. Also, the service offers the carrier the opportunity to improve his utilization both of inventory resources such as ships and containers, and of staff time and effort. Time-consuming amendments to shipping documents because of unclear L/C instructions should also reduce in frequency.

Faster release of cargo at the port of destination should also mean better utilization of the container fleet. Better information flows may also lead to fewer containers having to be repositioned empty. For bulk ship operators, the improved speed of the documentation process could lead to quicker port turn-round times with consequent reduction in charter costs or more trips per ship. The improved information flows may also lead to similar benefits for road, rail and air freight operators.

##### Benefits for the freight forwarder

The freight forwarder may use the Bolero Service to achieve improved staff productivity, better access to carrier information, and improved accuracy in administrative information processing. Together, these benefits should improve gross margins. The freight forwarder might also be able to extend the range of its services to customers wishing to outsource their logistics.

Freight forwarders are under increasing competitive pressure from integrated air freight companies who are moving into the smaller end of grouped cargo. These integrated carriers can offer very short transit times and highly effective administrative arrangements. By using the Bolero Service, freight forwarders may be able to offer similar benefits without making the huge infrastructure investments on which the success of the integrated carriers rests.

##### Benefits for the bank

On many short trade routes and with air transport, strict documentary processes are currently rarely applied as the goods tend to move faster than the paper. Similarly, many companies are dissuaded from using bank risk intermediation services such as collections and documentary credits as a consequence of the lack of transparency, delay and costs inherent in their use. The Bolero Service offers financial institutions the opportunity to redesign existing trade products and increase their use through the introduction of efficiency, transparency, speed and lower costs.

Source: This section is selected from Bolero Project - Project summary, September 1997, <http://www.bolero-project.com>.

system, and would provide additional security, facilitate trade and make new trading opportunities available.

## The ICC Electronic Commerce Project

The ICC has established an Electronic Trade Practices Working Group (ETP) with the objective of developing a set of self-regulatory rules and best practices for digital authentication and verification and promoting the establishment of an appropriate legal framework to secure electronic transactions.

One project of the ICC Working Group is the creation of electronic contracts (which is developed and tested by lawyers worldwide), electronic trade and settlement instruments (formerly the Generic Electronic Credit Instrument) which will include definition of the roles and responsibilities of various parties, risks mitigation, control of goods, negotiability (Certified Payment Obligation), and messaging conventions, and a generic transport document. The aim of this generic document is to have one message flow which can incorporate sufficient information for all various methods of transport to be used around the globe. The first stages of the project consist of investigatory work in order to come up with a set of rules and best practices to be produced by the ICC, within which dematerialized or electronic trade can operate globally. The aim is for these electronic commerce rules to have similar force in determining best practices in electronic trade as UCP 500 with regard to documentary credit trade (the aim is for the ICC rules for electronic trade to enter into force in April 1999).

One of the first products to come from the Electronic Commerce Project is the ICC's GUIDEC project. GUIDEC (General Usage for International Digital Ensured Commerce) provides a set of common definitions and business-generated best practices for certifying and ensuring electronic commerce. The GUIDEC proposes best practices in crucial security techniques, such as digital signature, which will be used by parties transacting over open networks to identify their electronic trading partner. GUIDEC is meant to be a set of rules for electronic commerce to the same degree that the UCP is for paper-based trade, with the aim of enhancing the ability of the international business community to execute secured electronic transactions and to establish a clear general framework and legal principles for ensuring and certifying digital messages.<sup>39</sup>

In conclusion, electronic trading system can be a solution if all parties wish to make it work. Some countries are not ready yet and Central banks are rigid in their rules for control (authenticity of signature, and numerous paper forms to enforce their regulatory programs). Legal constraints, Customs regulations, production of paper documentation and hand-written signatures represent barriers for the proper use of automated processing systems. The role of governments is, therefore, very important to the success of the electronic trading systems.

Electronic trading systems represent the future evolution of the actual traditional paper systems. The principal benefit of such change will be the speed with which the trade transaction can be processed. It will facilitate customs work since customs will be able to clear goods much more quickly (no need to wait until the necessary paper work is completed). Costs will be reduced since less paperwork will be produced. As to discrepancies, they will be considerably reduced since the data required for the various messages would be introduced only once; one set of agreed data would be used

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<sup>39</sup> Further information can be obtained through the ICC Internet Home-page, <http://www.iccwbo.org/guidec2.htm>.

by both seller and buyer throughout the whole trade transaction. Nevertheless fraud may still exist, but to a lesser extent, since electronic fraud would be more difficult to carry out (i.e. digital signature and other cryptographic techniques, if properly implemented, would be difficult to reproduce).

The whole system of paper-based documentary trade is based on the checking of documents. The system has survived, but the system can be abused. The requirement of strict conformity of the documents can be overlooked in certain cases where some little errors can be accepted. But in the case of computerization, the checking of the documents is crucial and, as a result, the latter can be rejected for simple details.

Obviously electronic trade systems require an entirely new way of thinking on behalf of all parties involved in trade and require strong rules to govern the procedures. As for banks, they will still have a role to play not only in supporting their client but also in controlling and processing the data required for the trade transaction.

Box 37

**Case Study**

**Confirming Bank "C" (Plaintiff)  
V.  
Shipping Company "Z" (Defendants)  
Broker "W"  
Seller "Y"**

⇒ **Case:** Presentation of documents under a confirmed letter of credit - UCP 1983 Revision - Antedated and false bills of lading.

Parties involved in the deal	→	<b>Issuing bank:</b>	<b>Bank, "I"</b>
		<b>Applicant:</b>	<b>Buyer, "X"</b>
		<b>Beneficiary:</b>	<b>Seller, "Y" (defendants)</b>
		<b>Confirming Bank:</b>	<b>Bank, "C" (plaintiffs)</b>
		<b>Owners of the vessel:</b>	<b>Shipping Company, "Z" (defendants)</b>

- By a contract signed in Apr 1993, and subsequently amended, the seller "Y" (defendant) agreed to sell about "4" tonnes of Iranian bitumen to "X". Among the document that were required under the letter of credit agreement, was a *clean shipped on board bills of lading* with shipment to be effected not later than Sep. 24, 1993, and negotiation of the documents to be effected not later than Oct 9, 1993. The credit was subject to ICC rules (UCP 400).
- A charter-party agreement was signed on Aug. 1, 1993 between "Y" and "X" (owners of the vessel "V") to carry the bitumen in drums from Bandar Abbas to Ho Chi Minh City. "W" acted as brokers to the seller "Y" in fixing the vessel.

- On Sep 17 1993, "V" began loading but, by Sep 24, loading was not completed and the seller "Y" could not properly present confirming documents under the letter of credit. The broker "W" requested the seller "Y" to obtain an extension of the L/C that would allow the loading to be completed and documents to be negotiated without recourse to backdating of bills of lading and other documents. No extension of the credit was obtained, therefore "Y", "Z" and "W" agreed on a plan which involved the issue of bills of lading falsely dated 24 September 1993. The purpose of issuing falsely dated bills of lading was so that the seller could present them to the confirming bank "C" in order to obtain payment under the L/C, despite the fact that shipment had not been completed by the last date allowed by the letter of credit. The reason that convinced the shipping company "Z" to agree on issuing antedated B/L was that they realized that their only hope of getting freight (and demurrage) was out of the proceeds of the L/C. "Z" were willing to approve of issuing ante-dated B/L provided they were given a letter of indemnity (LOI).
- On Oct. 1, the seller "Y" provided the shipping company "Z" with an LOI agreeing to indemnify them in respect of any liability loss or damage caused by antedated bills of lading.
- On Oct. 6, "Y" provided "Z" with a letter stating that the documents under the letter of credit would not be encashed prior to the completion of loading of the vessel.
- On Oct. 7, "Z" expressly authorized the broker "W" to sign and issue the bills of lading to the order of "I" (the notifying party of the seller). In accordance with those instructions "W" signed and released the original Ocean "Clean shipped on board" bills of lading and gave the day 24 September 1995 (when in fact the loading was not completed until Nov. 4 1993).
- On Oct. 15, the confirming bank "C", after examination of the documents, paid the seller "Y" "US\$ x amount" and submitted the documents to the buyer, who refused to pay for the documents. Since the bill of lading was endorsed by the issuing bank "I" to the confirming bank "C", "C" was able to sell the cargo.

☞ Issuance of bills of lading prior to completion of loading a cargo with the aim of presenting them to the bank for payment is an act of **maritime fraud** → In this action the confirming bank "C" sought judgment, against the shipping company "Z" and the broker "W" (claiming damages for deceit and/or negligent presentation and /or conspiracy arising out of the tendering of falsely dated bills of lading), and against the seller (claiming damages for deceit and/or conspiracy and/or restitution of the sum "n amount" paid by the confirming bank "C" to the seller "Y"

**The judgement:**

In 1995, the first judgement was given in favour of the plaintiffs (the confirming bank, "C") for damages to be assessed against the two defendants, the shipping company "Z" and the broker "W".

A leave to appeal was granted to the plaintiffs (confirming bank, "C") after the appearance of additional documentary evidence of fraud; and in 1998, the second judgment was granted also in favour of the plaintiffs with

- **The shipping company "Z"** being guilty of dishonest conduct, approved at the highest conduct,
- **the broker "W"** being guilty of dishonest conduct, and
- **the seller "Y"** guilty of dishonest conduct.

All three were equally responsible and must, therefore, equally share damages to the confirming bank.

## CONCLUSION

In these days, a letter of credit has a value only when it is issued by an acceptable bank, or confirmed by and acceptable and well-reputed bank. Letters of credit are sometimes deliberately issued with mistakes or with clauses that are different from the contract of sale, thus reducing the efficiency of a letter of credit as a secured payment mechanism. The letter of credit can be very expensive; with likely delays and problems deliberately built in, it is probably being used as a tool for non-payment.

On the other hand, with the increasing private sector involvement in commodity trading, companies are looking for quick cashflows and optimization. Letters of credit are becoming cumbersome and time-consuming and, in some instances, this leads traders to use the cash against documents (CAD) mechanism for some of their main buying transactions. It is a method of payment for goods in which documents transferring title are given to the buyer upon payment of cash. Payment is therefore made once the bill of lading is presented. This technique minimizes costs and facilitates payments to traders who are using it to pay for their purchases. Nevertheless, CAD does not provide the security which letters of credit offer. The risks that CAD bring do not allow every trader to use such a mechanism, especially when dealing with a new partner or in emerging markets. Moreover, it depends on national law. Traders in some countries are obliged by the law to use letters of credit in order to transfer funds.

Despite all the constraints listed above, it would seem that the irrevocable documentary letter of credit remains the most frequently requested method of payment because of the safeguards it offers in comparison with alternative methods. The most important advantage is found in the fact that the seller will be paid once his contractual obligations have been met. However, the buyer can still incorporate certain conditions into the letter of credit where these have to be met by the seller prior to any payment. This is not to say that the banks in any way place themselves in a position of enforcing the trade contracts or guaranteeing the quality of goods. In addition, the letter of credit carries the built-in protection of an expiry date and the maximum amount that may be drawn.

The role of the letter of credit remains relevant and it will continue to enable traders to do business effectively, even in an electronic environment.

A trader should reduce his vulnerability when dealing in commodities. He has to build a strategy and provide all the necessary elements which will guarantee the proper functioning of the transaction, even though it can be more expensive.

After setting a proper strategy plan, a trader needs to identify the risks and costs involved in the trade transaction (cost should be built into the export price). One should not forget trade principles and good trade practices. There are a lot of steps that an exporter should take in order to have a proper trade transaction:

- *Identify the areas of risk and build in a system to reduce the risk,*
- *a trader should be able to identify a reliable partner,*

- *signs a reliable contract - a trader can negotiate a letter of credit while signing a contract since all the requirements of the L/C are specified in the sales contract (clear understanding of the contract, i.e. who is carrying the goods, who is bearing the costs and risks of transportation). After negotiation, a trader has to think about the clauses to add in a letter of credit in order to have a secured letter of credit and security for payment after negotiation (how to get protection against default, fraud or negligence and what procedure to be followed in case of default, etc.).*
- *the trader should not have speculative attitudes,*
- *deal with reliable banks, and banks that can provide them with the necessary coverage (country and product coverage),*
- *have the right staff to deal with letters of credit - people capable of understanding and producing proper documentation.*
- *have an appropriate insurance contract,*
- *have reliable quality assurance,*
- *deal with a reliable shipowner, and*
- *understand the code of practice (UCP500).*

# **ANNEXES**





## **ANNEXES**

### **1. Standard Commodity Contracts**

- A. GAFTA contract No. 120: FOB Contract For Thai Rice.
- B. GAFTA list of contracts and rules.
- C. The Cocoa Association of London Limited. Market rules of standard contracts (section 14).

### **2. Letter of Indemnity (LOI) Problems - A proposal by IMB**

### **3. Maritime Advisory Exchange**

- A. ICC International Maritime Bureau.
- C. Lloyd's Maritime Information Services.
- B. BIMCO Services.

### **4. ICC activities**

### **5. SGS activities**

### **6 UNCTAD activities**

### **7. Documentary Credit Checklist**



## **Annex 1**

# **Standard Commodity Contracts**





















## **Annex 2**

# **Letter of Indemnity (LOI) Problems A proposal by IMB**









## **Annex 3**

# **Maritime Advisory Exchange**











# **Annex 4**

## **ICC Activities**

## Some of ICC main activities in relation to documentary credit

### I. ICC Arbitration

- i. ICC sustains an informal process to resolve disputes. ICC experts will respond to a request on behalf of the parties confronted with an altercation. The decision taken by the experts is not binding.
- ii. Among ICC's practical services to trade is the *International Court of Arbitration* which is one of the leading bodies for the resolution of international commercial disputes by arbitration. Arbitration decisions are in principle binding.
- iii. A new global service called the "*Documentary Credit Dispute Expertise*" (*DOCDEX*) has been created in 1997 to resolve international letter of credit disputes. In contrast with the ICC general arbitration service, the DOCDEX system deals only with disputes involving the documentary credits and their reimbursement. The programme is administered by the ICC Centre for Expertise. DOCDEX decisions are in principle non-binding. The aim of this new service is to reduce misunderstandings and delays by certain traders and banks in dealing with documentary credits. For further information consult ICC DOCDEX rules (ICC Publication No 577).

### II. ICC Technical advisory assistance

- iv. ICC provides advisory assistance on any question in connection with documentary credit incorporating the Uniform Customs and Practice for Documentary Credits (UCP). The technical advisory answer can be either an *unofficial answer* (by a simple reply from ICC technical advisor) or an *official answer* where it has to be confirmed by the ICC commission meeting.

### III. ICC Publication

- v. In addition to the several reference works related to international trade and involving several topics (including banking practice, international contracts, international arbitration, commercial fraud and joint ventures, etc...), ICC provides a *quarterly newsletter on documentary credits*, and *Opinions of the ICC Banking commission queries* which is published every one or two years.

### IV. Upcoming activities

- vi. ICC is in the process of creating a *documentary credit certification programme*. It is an educational testing service which will provide certain qualifications for the benefit of document checkers (the first examinations are to be given in the US and UK in November 1998 and elsewhere in the spring of 1999). A *study text* is also being designed to accommodate the certification programme. The programme is designed for an average person in documentary credit who has an all-around knowledge of the product (it is not designed at a level for senior managers).
- vii. ICC is also creating a *training project (DC-PRO)*. It is a multimedia training programme on documentary credits (supported by a CD-Rom basic tutorial on Documentary credit) which will be linked to a designated website. The website will be a reference library that will be updated, consequently providing up-to-date information about L/Cs and ICC issues (court cases, newsletters for example). The website would also allow DC-PRO users to communicate with one another. The objective of DC-PRO is to fill the gap of insufficient knowledge about documentary credits worldwide by providing access to adequate information. DC-PRO is scheduled to be produced by spring 1999.

Further information on the above list can be obtained through the International Chamber of Commerce, 38 Cours Albert 1er, 75008 Paris, FRANCE. [Http://www.iccwbo.org](http://www.iccwbo.org).



# **Annex 5**

## **SGS Activities**



## **THE SGS GROUP: EXPERTISE FOR OVER A CENTURY**

The SGS Group of companies is the world leader in inspection, testing and verification. It operates in more than 140 countries through its network of subsidiaries and laboratories, with 40,000 employees.

Founded in 1878, SGS initially specialized in controlling grain shipments. Today, the SGS Group is unique, thanks to its world-wide geographical coverage and the broad range of its services.

Core SGS services address agricultural products, minerals, petroleum & petrochemicals, consumer products as well as Industrial and non-destructive testing.

While continuing to expand its state of core business, the SGS Group has entered new business sectors that are less dependent on trade, such as services to the insurance industry, certification, services to the environment, health care, biosciences and manpower services. In addition, the SGS Group, via its Economic Affairs Division, develops tailor-made programmes for governments and international institutions, including import and export verification, services to customs and investment monitoring.

All SGS services have two important characteristics in common: they help to minimize risks and they provide assessment, verification and advice of an independent nature.

The SGS Group's development strategy is to increase its range of services and geographical coverage by developing new activities with promising long-term prospects.

### **Two fundamental principles: independence and impartiality**

Since it was established, the SGS Group has remained dedicated to its independence as a guarantee of its total impartiality. The policy of SGS is not to engage in any manufacturing, trading and financial activities which might compromise its independence and neutrality.

### **A commitment to quality**

The SGS Group has built its international reputation on a commitment to quality based on the individual and collective responsibility of all employees at the service of customers world-wide. SGS has broad experience in helping its customers to set up quality assurance and chain management systems.

### **Global services, with local solutions**

The SGS global capability allows clients to have their interests protected anywhere in the world with a "single source" solution.

Global services can only work through local know-how. SGS experts around the world are indigenous to the areas in which they work. They speak the focal language and are familiar with local conditions, business practices and traditions.

The SGS "single source" solution assembles people of different backgrounds and skills to work together by contributing their specific expertise. The international co-operation between local experts around the world has established the reputation of the SGS Group world-wide.

#### *Agricultural services*

This original SGS service, as mentioned above, goes back to the inspection of grain shipments. The scale of operations is quite different at present as SGS inspects millions of tons of commodities being moved worldwide each year. Thus SGS is continuing to be very much involved in inspection and monitoring services for international trade in agricultural products. These services help to ensure contract compliance and improve the speed and efficiency of transactions, the safety and reliability of the products and the respect of delivery and production schedules.

SGS has at its disposal highly-qualified specialists with know-how on all aspects of production and processing, environmental and crop protection factors, as well as quality control of horticultural produce. These specialists advise on how to determine which aspects should be given priority in a control system and what is the most suitable control method relating to the development of control systems for arable farming, horticulture and livestock, as well as the meat and fish sectors. These systems can involve the control of environmental impact during production and the processing of arable and horticultural produce. They also include logistic control schedules, whereby the whole flow of goods is followed, from preparing the land right up to the packaged product in the shops. This not only involves administrative control, but also sampling, company visits and laboratory analysis.

The tasks entrusted to SGS professional agricultural inspectors around the world are increasingly diversified: weighing, sampling, analysis, supervision of loading and discharging, tally, fumigation and guarantees of weight and quality. With more than 100 specialized laboratories in key agricultural countries around the world, SGS offers a unique range of testing capabilities for these particular services.

#### ***Consumer Products services - Retail & Supply Support***

Consumer Products services - Retail & Supply Support - address the entire sector of consumer products and services, including manufacturers, traders and retailers. Such services cover the total supply chain from product development through procurement and manufacturing to retailing. They allow SGS clients to efficiently manage the compliance with safety and other legal requirements, contractual performance specifications and delivery conditions of their business transactions.

Consumer Products services - Retail & Supply Support - involve specialized facilities and expertise in laboratory testing, product consultancy, process assessment and statistical product inspection including product/service certification. Flexible service packages can be tailor-made for optimal reliability and cost-efficiency according to a client's needs.

These services are available internationally for most non-food and food consumer products. SGS Consumer Product services are also provided to the service sector, and especially to hotel and restaurant chains.

#### ***Environmental services***

A broad range of environmental services is available as a consequence of the SGS's expertise in its traditional activities: laboratory and field testing for water, air and soil, regulatory and corporate compliance auditing, ecological surveys and site decontamination, impact studies, toxic waste disposal advisory services and stack emissions monitoring

#### ***Logistics services***

Logistics services are divided between warehousing, forwarding and stevedoring with specialized shipping agencies. The objective is to respond to market demand for packages of SGS inspection services.

### *Services to the Insurance Industry*

SGS experts provide insurance companies and brokers with impartial and reliable advice in the areas of loss adjusting, risk evaluation, damage prevention, investigation of claims, evaluation of losses, settlement recommendations and specific expertise in the fields of aviation, marine, environment, vocational rehabilitation, forensic analysis and the mobilization of resources in the event of catastrophes.

SGS is also active in the self-insured market, providing global insurance services to individual companies. These activities may include employee rehabilitation and evaluation services and the adjustment of workers' compensation claims.

### *Documentary Fraud Detection and Prevention in International Trade*

SGS has a comprehensive range of capabilities with respect to detection and assistance in the prevention of documentary fraud. Documentary fraud involves the use of false or forged documents in order to deceive. In the context of international trade, these documents are most often bills of lading and commercial invoices - or sometimes nothing more elaborate than a telex message. In many countries, documentary fraud is designed by those committing the fraud to lower duty and tax payments required for importing goods into that country.

International trade brings together people of different traditions, laws and institutions. Relationships are based upon trust. In the event of this trust being misplaced, or of something else going wrong, cultural difficulties between trading partners will be compounded by jurisdictional problems and the very nature of the international trade transaction itself. For this reason, SGS has services which can assist in the prevention and detection of documentary fraud. These services include pre- and post-shipment verifications on behalf of buyers, sellers and client governments and may encompass much more than just physical verification. In addition, by examining not just obvious (commercial invoices and bills of lading), but subsidiary information (such as files, faxes, correspondence, packing notes, etc.) SGS can further assist in the detection of documentary fraud.

With the growth of automated computing and technological change, documentary fraud has become an even more significant issue in that almost any document can be scanned, modified and reproduced to resemble the original. In this environment, the expertise of SGS is essential to assist in fraud detection and prevention - in fact, many governments throughout the world have placed their trust in SGS to address this issue via specialized inspection services.

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## Annex 6

# **UNCTAD Activities**





## **INTRODUCING THE UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT (UNCTAD)**

### **UNCTAD'S MANDATE**

UNCTAD, based in Geneva, Switzerland, is the focal point within the United Nations system for the integrated treatment of development and interrelated issues in the areas of trade, finance, technology, investment and sustainable development. Its main goals are to maximize the trade, investment and development opportunities of developing countries, and to help them face challenges arising from globalization and integration into the world economy on an equitable basis. UNCTAD works in the following thematic areas:

#### ***International Trade in Goods and Services, and Commodities***

Helps developing countries to maximize the positive impact of globalization and liberalization on sustainable development by helping them integrate effectively into the international trading system; analyzes the impact of the Uruguay Round Agreements on trade and development, and helps countries respond to the opportunities arising therefrom, including through enhancement of their export capabilities; promotes diversification by commodity-dependent developing countries; promotes the integration of trade, environment and development; analyzes issues related to competition law and policy; assists countries in formulating policies and legislation and in institution-building.

#### ***Globalization and Development Strategies***

Examines trends in the global economy and evaluates their impact on the development process, studies questions related to financial flows and indebtedness, and helps developing countries manage their debt; undertakes macroeconomic policy analysis in the context of interdependence among countries and sectors of the economy; analyzes specific development challenges and successful experiences; develops databases and provides statistical information related to trade and development.

#### ***Investment, Technology and Enterprise Development***

Examines global trends in foreign direct investment (FDI) flows; the interrelationships between FDI, trade, technology and development; the development implications of a possible multilateral framework on investment, analyzes policies and mechanisms to support the development of micro, small and medium-sized enterprises; identifies policies to favour technological capacity-building and innovation in developing countries; undertakes science, technology and innovation policy reviews, to identify options for national action; helps developing countries exploit opportunities for enterprise development and assists developing countries to promote inward investment and to exploit new opportunities.

#### ***Services Infrastructure for Development, and Trade Efficiency***

Helps developing countries in improving the efficiency of their trade-supporting services through technical cooperation programmes; supports the formulation of national policies and regulations promoting services infrastructure for development, trade facilitation and trade efficiency; assists developing countries in assessing the efficiency of their trade-supporting services and in implementing best practices; contributes to the development of new services to assist the informal sector and micro-enterprises, particularly in the area of micro-credit; promotes global electronic commerce by facilitating access to information technologies for all actors in international trade, particularly through the Global Trade Point Network.

#### ***Least Developed, Land-locked and Island Developing Countries***

Coordinates UNCTAD's work on LDCs, including the follow-up to the October 1997 High-Level Meeting on Integrated Initiatives for Least Developed Countries' Trade Development and the provision of technical assistance in the form of Integrated Country Programmes; assesses the economic and social performance of LDCs in the context of their international and domestic environments; and helps implement the Programme of Action for the LDCs for the 1990s, the Barbados Programme of Action for the Sustainable Development of

Small Island Developing States, and the Global Framework for Transit Transport Cooperation between Land-Locked and Transit Developing Countries and the Donor Community.

## **UNCTAD'S WORK ON COMMODITIES**

At its ninth conference in 1996, UNCTAD gave a new direction to its work on commodities, emphasizing four key areas: commodity diversification; natural resource development; market trends and transparency; and risk management and finance. The focus of UNCTAD's work is on maximizing the contribution of the commodity sector to economic and social development, in the context of a liberalizing and globalizing world economy. UNCTAD's work, consisting of a balanced mix of analysis, policy advice and direct assistance, responds to the needs of both the public and the private sectors. It is based on a forward-looking approach aiming to assist commodity-dependent countries in their efforts to adapt their policies and strategies, seeking innovative solutions to the problems they encounter.

### ***Diversification in the new international economic environment***

- Diversification in the new international economic environment: product/sector-based challenges and emerging opportunities in the multilateral trading system that affect the diversification process and interests of commodity-dependent countries.
- The scope and efficient implementation and social implications of Government diversification policies;
- Assistance in the design and implementation of national diversification policies and implementation;
- Assistance to commodity-based enterprises in international markets, in terms of complexity, quality requirements, information exchange and multiplicity of rules;
- The positioning of enterprises from developing countries in international markets where concentration seems to be increasing;
- The role of formal and informal institutional structures, including their communication and support functions;
- The potential benefits of commodity-based clusters; evaluation of successful experiences.

### ***Natural resource management***

This area of work aims to contribute to economically and ecologically sustainable management of natural resources, particularly in developing countries. The methods used include: provision of advice and capacity building to governments and industry, organization of training events, issues-oriented research, publications, dissemination of information through the Internet and presentations. While technical cooperation activities are mainly carried out together with governments, the programme maintains extensive contacts and cooperation with industry, NGOs and other elements of civil society. The focus is on actions that governments and civil society can take to directly promote and support sustainable natural resource use.

- Support in the formulation of macro- and micro-economic policies and legislation in the mineral sector as well as in the preparation of mining laws, mining taxation systems, and foreign investment frameworks;
- Development of frameworks for consultation with local communities and indigenous peoples;
- Advice and training in regional planning and participatory development in areas dependent on natural resources exploitation;
- development and application of frameworks for regional planning that facilitate cooperation between national and regional governments, industry and local communities;
- Support to policy formulation and capacity building in environmentally sustainable natural resources management and to the identification and promotion of environmentally preferable natural resource based products and production processes;
- Assistance with regulatory issues, such as the preparation and implementation of environmental regulations.

### ***Commodity risk management and finance***

UNCTAD has evolved as one of the leading international organizations assisting commodity-dependent

countries to enhance their capacity to use modern commodity risk management and finance tools. Work in this area involves policy advice, training and technical cooperation activities, geared both to the private and the public sectors and with a focus in the following areas:

- Processes of integration between commodity marketing, risk management and finance;
- Problems of access to commodity risk management and finance markets; work encompasses training, the development of manuals, capacity-building for banks and farmers' associations, etc;
- Prudential rules for the safe use of price risk management instruments;
- Possible legal and regulatory reforms to improve access to international commodity risk management and finance markets and to lower the cost of this access (e.g., means to reduce sovereign risks);
- The functioning of commodity exchanges and the role of new groups of non-trade related participants in commodity futures markets;
- The development of regional/national commodity exchanges and new futures contracts;
- National stabilization arrangements, in particular the use of market-based price risk management tools in combination with national commodity stabilization funds;
- Structured commodity finance, including asset-backed financing and the use of commodities as collateral, particularly through warehouse receipts.

### ***Commodity market trends and transparency***

This work area aims to monitor and analyze the evolution of the world market for major commodities, to disseminate commodity market information and to convene and service, as appropriate, meetings related to the negotiation, re-negotiation, or the functioning of international commodity agreements (ICAs). Activities include, *inter alia*, the following:

- In-depth analysis of recent development in commodity markets and their prospects, with particular emphasis on commodity-dependent countries;
- Statistical publications covering comprehensive data on commodity trade and related issues (e.g., the Handbook of World Mineral Trade Statistics and the Monthly Commodity Price Bulletin);
- Coordination of activities of international commodity bodies and monitoring developments in the ICAs and international study groups set up under UNCTAD's aegis;
- Advisory and technical cooperation activities on a wide range of issues related to production, consumption, trade, and international cooperation in commodities;
- Establishment of an Exchange of Information and Partnership Center on Internet, to facilitate international commerce in commodities;
- Cooperation with the business sector in the diffusion of commodity trade information with emphasis on facilitating access by developing countries.

*For further information on UNCTAD's work on commodities, please contact:*

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## **Annex 7**

# **Documentary Credit Checklist**



## **Documentary credit checklist**

### 1. The Letter of Credit

1. Does the L/C need to be confirmed?
2. Do all terms and conditions in the letter of credit conform with the terms and conditions of the sales contract? Can all the details and conditions stipulated in the letter of credit be met?
3. Are the names and addresses of the contracting parties entirely correct and complete?
4. Is the description of goods correct and complete, including weights, shipping marks (description of goods to be shipped if insufficient or too detailed can lead to discrepancies)?
5. Are unit prices and total price for goods in accordance with the original quotations?
6. Will total amount cover all costs allowed by the L/C (e.g., documentation, transportation, insurance)?
7. Are terms of payment and currency of payment clearly stated? Is payment at sight or at a later date? Is it drawn on the exporter's bank or importer's bank?
8. Does the letter of credit time validity give enough time to cover the whole transaction? Can all the terms and conditions of the L/C be complied with before it automatically expires (i.e. production and packing, inspection, shipment, assembling and checking documents and finally presenting them to the bank)? Do the shipping terms give the seller adequate time to produce and have goods ready for shipment on the required date? Can all documents be obtained in the exact form as requested and within the validity period of the L/C? Is there enough time after delivery to collect and present documents to the bank for payment?
9. Who is responsible for insurance? What is the insurance coverage?
10. Are the delivery terms correctly stated (e.g Ex Works, FAS Port of Import, FOB Port of Export, CFR Port of Import, CIF Port of Import)?
11. Who pays the transportation costs?
12. Are Partial Shipments allowed (i.e. must complete order be contained in one shipment or more than one shipment is allowed)?
13. Is transshipment allowed (i.e. can goods be unloaded and transferred to another vessel between the port of export and the port of import)?

### 2. The Commercial Invoice

1. Does all the information contained in the commercial invoice conform with the instructions of the L/C?
2. Are terms of delivery clear (i.e. Incoterms)?
3. Are terms of payment and currency of payment clearly stated?
4. Is the customer's order number notified on the invoice?
5. Are unit descriptions, measures and prices recorded the same way on all other documents? Are they exactly as stated in the Letter of Credit? Has the required number of copies been made?
6. Are the port of loading and the port of discharge indicated?
7. Will a commercial invoice suffice? Is a Customs or consular invoice needed?
8. Are all charges in accordance with the original quotation?
9. Has the invoice been signed? Has it been dated (as per the L/C requirements)? Has it been assigned a unique identification number?
10. Does it need to be authenticated by a Consulate?

### 3. The Certificate of Origin

1. Is a certificate of origin required by the letter of credit, purchase order, or destination country?
2. Is the chamber of commerce or consulate willing to authenticate the statements that are needed on the certificate of origin?
3. Can a certificate issued in the country of origin be furnished on time?
4. Is a special format required by any trade agreement or by the destination country?
5. Do the name of the consignee and the consignor, their addresses, shipping details, item descriptions, quantities (the quantity of goods being shipped should be clearly denoted in the units used in the tariff of the importing country), marks and pieces/packages numbers conform with the commercial invoice, bill of lading and packing list?
6. Is the country of origin properly stated?
7. Has the certificate of origin been signed? Reviewed and sealed by a chamber of commerce? Notarized? Is a Consular visa required?

### 4. The Inspection Certificate

1. Do the details in the certificate conform with the terms of the letter of credit?
2. Does the certificate contain a full description of the goods (including quality requirements and standards) as defined in the L/C and commercial invoice?
3. Is the factor of conversion considered in order to obtain the specific weight of the merchandise?
4. Is the scope of the inspection company clearly defined?
5. Has the certificate been signed? Has the authenticity of the inspection certificate (or the copy received) been verified?

### 5. The Packing List

1. Are shipper and consignee (or intermediate consignee) clearly stated?
2. Does the list contain all the necessary information concerning the packing (i.e. size, types, number of packages, gross weight, outside measurement and content)? Do all item descriptions and units of measure conform with the letter of credit and the commercial invoice?
3. Is the total gross weight of the consignment separated from the net weight of the consignment?
4. Are the carton "marks and numbers" accurate?
5. Does the packing list state the invoice reference and the date of the invoice?
6. Does the packing list conform to the importing country's requirements?
7. Any additional information required by the L/C?
8. Is the packing list duplicated in the language of the foreign destination?
9. Have the required number of copies been made? Packed in each carton?
10. Has a proper envelope for the packing list document been prepared, to be attached to the cargo?



## 6. Insurance Certificate

1. Is the insurance of the right type (i.e. whether the exporter must present an insurance policy or insurance certificate; this is usually stipulated in the terms of the letter of credit)?
2. Is all the necessary shipment information provided on time (i.e. before shipment voyage starts)?
3. Is the document endorsed (if necessary)?
4. Does the insurance policy cover transshipment (if necessary)?
5. Are the description of the goods, the "marks and numbers", the shipping route (full description of the voyage), the vessel name (or flight details), the name and address of the beneficiary, name of the agent who would be authorized to settle the claims, the currency used, and the actual amount of insurance, conforming with the details given in the letter of credit, commercial invoice, and other transport documents provided?
6. Is the date of issue the same as, or earlier than, the date of the transport?
7. If the goods have been loaded on deck, does the insurance document cover "on deck" risks?
8. Is the insurance document signed?

## 7. Bill of Lading

1. Are the consignee, shipper and notifying party clearly defined as stipulated in the letter of credit? Do descriptions of goods, weight or measures, marks and numbers conform with the L/C and other transport documents (i.e. the commercial invoice and packing list)? Are they accurate?
2. Does the date of shipment conform with the requirements stipulated in the L/C?
3. Are the port of loading and discharge exactly as stipulated in the L/C?
4. Are the method of transportation, the shipping route (destination of the cargo), the carrier, the vessel number stated and accurate?
5. Is transshipment allowed (if necessary)? If so, does the B/L cover the whole transport route?
6. Is the bill of lading marked "charter party", if required? Otherwise, does the B/L contain the terms of carriage?
7. Is the ocean bill of lading marked "on board," if this is required by L/C?
8. Is the bill of lading noted "to order" as stipulated in the letter of credit (i.e. are the goods consigned as in the L/C to the order of a named person or firm, or to a named consignee without "to the order" notation)?
9. Is B/L marked "prepaid" if freight charges are included on the commercial invoice?
10. Are any of the items classifiable as Hazardous Materials? Are special hazardous requirements needed?
11. Is the bill of lading "clean", i.e. without any negative clause referring to the condition or packing of the goods (e.g. 'iron bands rusty', 'two cases defective' '10 bags torn', 'part of goods rotted')?
12. Is the bill of lading in a full set of proper originals? Does the number of originals in the set appear on each document?