Negotiation of Documents by Banks under Documentary Credits Available with Another Bank

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It is a common practice among commercial banks operating in Sri Lanka to negotiate documents under documentary credits available with another local bank against an indemnity obtained from the beneficiary. This has become a routine practice and is done at the request of the customers who are the beneficiaries of the credits. We find that practices are sometimes evolved and applied in general without due consideration being given to the risks involved with different situations, which may result in losses and having to face embarrassing situations due to unprofessional conduct. This article aims to examine more closely the merits and demerits of this practice and whether the banks are doing the right thing in continuing this as a routine practice.

Sub-article 6.a. of UCP600 states 'A credit must state the bank with which it is available or whether it is available with any bank. A credit available with a nominated bank is also available with the issuing bank'. Since practically every credit, if not all, received in Sri Lanka is issued subject to UCP600 such credits will therefore have either a nominated bank or will be available with any bank in Sri Lanka.

UCP600 in sub-article 9.b. states 'By advising the credit or amendment, the advising bank signifies that it has satisfied itself as to the apparent authenticity of the credit or amendment and that the advice accurately reflects the terms and conditions of the credit or amendment received'. Therefore, for the purpose of verification of authenticity, an issuing bank must use one of its correspondent banks to advise a credit. The issuing bank goes a step further by making the credit available with that advising bank in order to give their correspondent bank an opportunity of getting more business and thereby enhance their correspondent banking relationship. Even when the beneficiary requests the applicant to make the credit available with their bank the issuing bank usually names that bank in addition to the advising bank as the banks with whom the credit is available.

Sub-article 14.a. of UCP600 states 'a nominated bank acting on its nomination, the confirming bank, if any, and the issuing bank must examine a presentation to determine on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation'. Therefore when an issuing bank requests a correspondent bank to advise a credit to the beneficiary after adding their confirmation it must make such credit available with the confirming bank, or else the bank which is requested to add their confirmation to the credit may not agree to accede to their request.

When a beneficiary presents credit complying documents to their bank under a credit available with another bank in Sri Lanka, the usual practice is for the bank to quote discrepancy 'LC restricted to …. Bank'. The bank more or less prompts the beneficiary to submit an indemnity to cover the so called discrepancy. The beneficiary is also happy to transact this business with his own bank rather than with another bank with whom the credit is available. The beneficiary's bank is also happy to handle the business since it brings them additional income by way of interest and exchange income whilst the risk is covered by the beneficiary.

A detailed examination of this issue brings out some interesting facts. Firstly, can this be called a discrepancy? Of course it is definitely not a discrepancy but a deviation from process that is required in the credit. Secondly, what is the form of indemnity taken? Is it the usual format that is used to cover discrepancies and stating this as a discrepancy, which is the practice adopted by some banks? These issues give rise to two possible problems. If the indemnity is taken is in this form such indemnity taken by the bank is not legally valid. The second problem is a question of good governance. Shouldn't the beneficiary's bank advise the customer to give instructions to present the credit complying documents to the bank with whom the credit is available rather than trying to add to their income at the risk and expense of their own customer?

The bank negotiating the documents obtains an indemnity from the beneficiary to cover themselves against delay or non-receipt of reimbursement. This means the beneficiary is taking the risk for such eventuality by having to make good the amount advanced, the interest for the period the bank is out of funds, as well as any loss in exchange incurred by the bank. As far as the bank is concerned they are making money at the expense of its customer.

There are occasions where this practice as a routine is extended to even credits, where the bank with whom the credits are available has added their confirmation to the credits. Why do beneficiaries disregard a confirmation and request negotiation through their bankers? The objective of a confirmation is to have the drawing honoured / negotiated without recourse to the beneficiary. Recourse here means the legal right to claim the amount advanced together with other losses incurred from the beneficiary in the event the issuing bank does not honour or delays honouring the drawing. It appears to be the ignorance of the beneficiaries in not knowing the benefit they are foregoing by doing so. Furthermore, the confirmation commission that has been paid which finally has to be borne by the beneficiary either directly or indirectly by way of an inflated price for the goods purchased is a waste. Is the beneficiary's bank doing the right thing in negotiating and thereby making the beneficiary loose the benefit of the confirmation? Is the bank acting in a fair manner vis-à-vis their customer by not educating their ignorant customer the benefit of getting the drawing honoured / negotiated without recourse by the confirming bank, and by looking after their self interest to earn the interest and exchange margin on that transaction?

Another important issue is whether a bank with which the credit is not available can negotiate documents drawn under such a credit? In article 2 of UCP600 Negotiation is defined as 'the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank)

and/or documents under a complying presentation , by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank'. Therefore, the question is whether a bank which is not a nominated bank, negotiate documents in accordance with the interpretation given in the ICC rules and obtain an indemnity from the beneficiary where the consideration is stated as 'negotiating'. Should the indemnity then use 'purchase' instead of 'negotiation'?

Another issue that needs attention is whether an issuing bank can delay or refuse reimbursement for a drawing made under a credit by a bank other than a nominated bank. Technically a bank other than a nominated bank has no authority to negotiate a presentation made under a credit which is not available with them. However, in practice this may be viewed in two ways In the case of the issuing bank as well as the country in which it is located is of low or negligible credit risk, the issuing bank can take a negative attitude and refuse to reimburse them direct or delay providing the reimbursement. On the other hand if the credit risk of the issuing bank or the country in which it is located is high it may be viewed positively as the negotiating bank has confidence in the issuing bank and/or its country to advance funds in spite of the perceived risk and may provide reimbursement without any delay. There are occasions where the issuing bank makes the payment through the bank with whom the credit is available so that the bank is aware of the drawing and makes a note of it in their records. This may give rise to some delay in receiving reimbursement.

One may argue that in terms of article 6.a. a credit available with a nominated bank is also available with the issuing bank. The issue then is whether such a presentation to the issuing bank by the beneficiary's bank acting as an agent of the beneficiary, should be accompanied by the original credit advice. In the alternative would a certification by the beneficiary's bank to the effect that it has endorsed the drawing in the original credit advice be acceptable? The decision will be solely with the issuing bank.

All this while, we were referring to drawings which were complying presentations. In the event of there being even one discrepancy the situation is totally different. In such situations the confirming bank or the bank with whom the credit is available will require an indemnity from the beneficiary countersigned by their bank in order to negotiate documents. In such an event it makes good business sense for the beneficiary's bank to negotiate documents by covering themselves with a suitable indemnity from the beneficiary and obtaining the benefit of the interest and exchange income whilst avoiding a contingent liability arising from countersigning an indemnity to the confirming bank or the bank with which the credit is available with.

In conclusion, this can be used as a routine practice when a presentation is discrepant. If not in the case of a confirmed credit make it a practice to present documents to the confirming bank. If it is not a confirmed credit but the bank with which it is available is prepared to negotiate, shouldn't the beneficiary's bank present the documents to that bank rather than negotiating the documents against the beneficiary's indemnity? The other issue is whether the wording of the indemnity in such a situation is not the routine format but is specially formatted to take care of the special circumstance.