

## **RISKS UNDER IMPORT DOCUMENTARY CREDIT TRANSACTIONS**

Documentary Credits provides the seller and the buyer with independent assurance in the exchange of goods for payment. The seller has the irrevocable undertaking of the Issuing Bank that the seller will receive payment provided the following conditions are satisfied.

1. The seller presents the documents as stipulated in the credit
2. The terms and conditions of the credit have been complied with.

The buyer, as Applicant of the Credit, has the undertaking of the Issuing Bank that no payment will be made under the credit unless the above conditions are complied with.

In view of the comfort provided to both the seller and the buyer by the independent undertaking of the Issuing Bank, Documentary Credits are often a preferred method of payment in International Trade.

The risks under Documentary Credits arise from the complexities involved due to more than one country being involved in a transaction. Thus there may be differences in the laws, customs,

Where goods are lost or damaged in transit the owner of the goods at the time of such occurrence will look to their insurers for financial recompense. Applicants should ensure which party is responsible for arranging the insurance cover when agreeing to the terms of the sales contract with the beneficiary, and be satisfied that the level of cover arranged provides an appropriate level of protection.

### **1.5 Exchange Risk**

In Letters of Credits where the currency is not that of the country of the applicant there may be a difference in exchange rates between the time the credit was issued and the time when settlement is made. In case where no Forward Exchange cover is available, the applicant may have to pay more than the anticipated price which may reduce the profit margin or sometimes incur a loss.

Forward foreign exchange contracts may provide a hedge against this risk where such cover is available to the Applicant although the exchange rate of the cover may turn out to be less attractive than the market rate available. This process may, however, lock in the prices and associated profits in a transaction.

## **2. Risks to the Beneficiary**

### **2.1 Failure to comply with Credit Conditions**

The main risk for the beneficiary is that payment will be refused by the Issuing bank because the documents do not comply with the terms and conditions of the Documentary Credit.

Beneficiaries can minimize this risk by requesting amendments to the credit terms if any of the conditions appear to vary from the commercial agreement, or if the Beneficiary would find it difficult to satisfy any of the Credit conditions. Any amendment required must be received before the goods are shipped or the service is supplied.

### **2.2 Failure of, or Delays in Payment from, Issuing Bank**

In an unconfirmed Documentary Credit transaction the beneficiary faces the risk of failure of the Issuing Bank and the country risk relating to the country where the Issuing bank is located. This poses a problem in cases where the country concerned lacks adequate foreign exchange reserves where the Issuing bank becomes insolvent and the beneficiary may need to rely on payment for the goods being received direct from the Applicant in the case of Country risk payment may be prevented or delayed by incidents such as balance of payments difficulties affecting the country of the Issuing Bank and by Government restrictions on transfers of funds outside the country. The beneficiary can mitigate these risks by obtaining a confirmation of the credit by a bank in the Beneficiary's country.

### **2.3 Credit issued by party other than Bank**

The risks to the Beneficiary mentioned under 3.2 above may increase in case the issuer of the Documentary Credit is not a bank. If Beneficiaries have any doubts as to the status of the issuer of the Documentary Credit, or if credits are clearly issued by a non-banking corporation, they should exercise caution before shipping goods and placing trust on the Documentary Credit.

## **3. Risks to the Issuing Bank**

### **3.1 Insolvency of the Applicant**

This is the principal risk to the Issuing Bank. Issuing Bank may minimize this risk by obtaining security from the Applicant and/or issuing the credit enabling the Issuing Bank to retain either

title to the goods (eg. by means of negotiable bills of lading) or control over the goods (eg by having goods consigned to the Issuing Bank) In such circumstances it may also seek confirmation from the Applicant that adequate insurance cover has been arranged.

#### **4. General Risks**

##### **4.1 Fraud Risk**

The main fraud risk relating to Documentary credit, is the risk that payment will be obtained for non-existent or worthless merchandise against presentation by the beneficiary of forged documents. This is a risk borne by the Credit applicant.

The second and rare situation is the risk that the credit itself may be forged. This could induce a beneficiary to ship goods or perform a service against an apparent bank undertaking to pay that in fact did not exist. In this event, the beneficiary will have no enforceable claim against the bank named in the credit because either that bank did not in fact issue the credit or the bank named in the credit does not exist.

##### **4.2 Country Risk**

This is the risk that performance of the Documentary Credits may be prevented by Government action outside the control of the Parties. This may occur for instance where a Government imposes foreign payment restrictions on imports/exports prohibitions after a Documentary Credit has been issued but before it has been fully performed.

##### **4.3 Legal Risk**

Legal risk concerns the possibility that performance of a Documentary Credit may be disturbed by legal action relating directly to the parties and their rights and obligations under the Documentary Credits.

One example of this is where a dispute arises under the commercial contract between the applicant and the beneficiary. The applicant starts a court action against the beneficiary. In the course of these proceedings the credit applicant may obtain a court order such as an injunction that prevents the issuing bank from paying under the Credit pending the resolution of the dispute underlying contract. This places the issuing bank in a situation where it cannot honour its obligation.

The legal risk may be complicated by the fact that Documentary Credit operations may involve parties in two or more indifferent countries.

##### **4.4 Force Majeure**

This situation arises if performance of a contract, including an obligation under a Documentary Credit relationship is prevented by external factors such as natural disasters or armed conflicts. For example, a Nominated bank is physically prevented from checking the documents and sending them to the issuing bank when widespread rioting forces the bank to close its offices and postal services are disrupted.

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