



International Chamber of Commerce

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Department of Policy and Business Practices

When a non-bank issues a letter of credit

Commission on Banking Technique and Practice, 30 October 2002

Because of widespread interest in this subject, the ICC Banking Commission has decided to post its official Opinion on non-banks and letters of credit on the ICC web site. The Opinion follows.

Articles 1 and 2 of UCP 500

When a non-bank issues a letter of credit

Query

We have been receiving a significant number of enquiries about letters of credit which are advised by some banks in the usual way, but are actually issued by a corporate, or the finance arm of the corporate and not a Bank.

These predominantly corporate L/Cs from Country U are "advised" by banks on their letterhead in a SWIFT MT 700 format, and to all intents and purposes appear to be bank issued L/Cs, with the requirement to present documents to the advising or transferring bank, where documents will be processed and payment made after receipt of funds from the "issuer".

Invariably they incorporate clauses to the effect that the L/C is subject to the UCP, and that where the UCP refers to "issuing bank" then the issuer is to be construed as acting in all respects as the "issuing bank".

Notwithstanding the fact that legally any entity can issue a letter of credit, our understanding is that the UCP only contemplates as issuers banks, on the basis that the issuing bank is undertaking a third party, independent guarantee of payment to the seller (beneficiary). It is this independence of a banker's letter of credit that is key to the payment undertaking.

The requirement by the seller for a letter of credit is two-fold: first that he has a guarantee of payment, and second that he can use the credit to raise pre-shipment finance from his banker.

In the case of the corporate L/C as we understand it, the guarantee of payment is not normally by an independent third party, and, as such, the credit risk is that of the corporate entity issuing the credit. Similarly when documents are presented under the L/C for negotiation, that negotiation if any, is based on the risk of the issuing entity, i.e. is corporate, not bank risk.

We would be grateful if the ICC Commission on Banking Technique and Practice would advise on the following:

1. Is it acceptable practice for a bank to advise a corporate letter of credit in the same way as a bank-issued letter of credit without drawing attention to the "non-bank" nature of the issuing entity? Does the Commission consider appropriate guidelines should be published? If so what will these say?

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2. What is the position if the corporate issuer were to apply for liquidation, bankruptcy, or protection from creditors (e.g. file for Chapter 11), and how different is the position to that of when a bank is unable to meet its obligations.

Analysis

The UCP reflects that state of practice, namely a situation where the issuer or other actor on a letter of credit is a bank. As a result, although there is no affirmative rule in the UCP prohibiting entities that are not banks from issuing, confirming, paying, negotiating, or advising letters of credit, its vocabulary ("issuing bank", "confirming bank", etc.) assumes that these entities are banks.

This assumption is based on the recognition that there are three principal advantages to bank issuance and handling of letters: namely that banks have the operational expertise to handle issuance and presentation under letters of credit in a professional manner, that they have the tradition of independence from the underlying transaction which is the basis of the commercial reputation of the letter of credit, and that in virtually all countries banks are specially regulated with a view toward protecting those who rely on their undertakings.

These matters are of considerable importance to the integrity of the letter of credit as an instrument of commerce and to its dependability as an instrument of payment.

However, neither the Commission on Banking Technique and Practice nor the UCP can determine who is empowered to issue letters of credit under local law nor who may issue its undertakings subject to the UCP. That restriction on the issuance of letters of credit is a regulatory matter under local law should be obvious. In some countries, non-banks can issue letters of credit, although there may be limitations where they are used in consumer situations. In other countries, issuance is limited to financial institutions, but it is less clear that only banks constitute financial institutions. As a result, non-banks that are financial institutions, such as insurance companies, can issue letters of credit in some countries.

It may be less apparent that the UCP cannot itself limit the scope of its application. The UCP is a set of voluntary rules of practice. The rules can be modified or excluded by the undertaking that is issued subject to them as is recognized in UCP 500 Article 1 (Application of UCP) (The provisions "are binding on all parties thereto, unless otherwise expressly stipulated in the Credit."). Issuance by a non-bank constitutes such a modification. Even if the UCP expressly prohibited issuance by a non-bank, this prohibition could be modified because the UCP is not a legislative act that can restrict the manner in which it can be applied.

Where a letter of credit is issued by a non-bank, the non-bank issuer should be held to the same obligation and standard of care as would a bank. In either case, the obligation is to pay against the presentation of documents that comply with the terms and conditions of the credit and that determination is to be made based solely on the documentary presentation and not on the status of reimbursement obligations or the underlying transaction, and local law should apply the same principles to an independent undertaking regardless of who makes it.

Having concluded that a credit can be issued subject to the UCP by a non-bank, however, does not mean that it is prudent for a beneficiary to accept such a credit. Issuance through an advising bank does mitigate the issue of whether the credit is authentic and presentation of documents to a bank does reduce some operational risks. There is, nonetheless, the risk of the creditworthiness of the issuer and country risk. These risks apply equally whether the issuer is or is not a bank and a beneficiary should always assess whether it is prepared to accept the credit and country risk associated with the issuer. If not, it should require confirmation by an entity with which it is comfortable.



There remains, however, an additional risk that may not be apparent to beneficiaries, namely the risk of neutrality of the issuer. This risk is somewhat more intangible but is very important. It is the risk that, when presented with documents, the issuer may be influenced by factors other than whether they comply on their face with the terms and conditions of the credit and may exercise certain discretionary judgments in examining documents against the beneficiary where it would not otherwise do so if external factors were different. While this risk is not confined to non-banks, the reputation of individual banks for integrity is well known in the letter of credit community and one which most banks that regularly engage in letter of credit practice work hard to maintain. It is less apparent that when faced with a poor credit decision, an insurance company will approach the problem in the same way as would a letter of credit banker rather than as an insurer, which may be inclined to reject all arguable claims and engage in litigation to settle any colourable dispute.

Similar concerns would apply to corporate issuers on behalf of themselves or affiliated companies, even though two-party letters of credit are recognized by UCP 500 Article 2 (Meaning of Credit) ("and on the instructions of a customer (the 'Applicant') or on its own behalf").

For these reasons, it is in the interest of banks generally to inform corporate letter of credit users of the advantages of having a bank's obligation, either as the issuer of a credit or as the confirmer of a credit issued by a non-bank. There would be no objection under standard international letter of credit practice to informing specifically the beneficiary of such a credit as to the nature of the issuer in addition to emphasizing that the advising bank assumes no liability, although in the absence of agreed standards such a decision should rest with the individual bank involved.

Of course, where the manner of issuance misleads the beneficiary into believing that the issuer is a bank, the advising bank may expose itself to liability. Ultimately, however, the decision as to whether or not to accept the risks associated with a non-bank issuance rests with the beneficiary.

Conclusion

1. It does not "violate" the UCP for a non-bank to issue a credit subject to the UCP even though such issuance is not contemplated in the rules. The UCP does not specifically provide for bank advice of non-bank issued letters of credit. Such an advice should accurately identify the issuer and indicate the advising bank's limited role. If the form of advice refers to the "issuer" as "issuing bank" or otherwise gives the impression that it is a bank, it is recommended that the advice affirmatively disclose the non-bank status of the issuer in order to correct any mistaken impression caused by such reference.
2. The consequences of insolvency are a matter for local law, whether the insolvency is that of a bank or non-bank issuer. In either case, however, the beneficiary assumes the risk of the creditworthiness of the issuer unless it is offset by obtaining confirmation or credit insurance.

Rome, 30 October 2002