

A Brief Discussion on the Risks and Countermeasures of Letter of Credit Settlement after the Epidemic

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Abstract

With the rapid development of international trade, letter of credit has gradually shown its defects. Especially after the 2022 pandemic, many countries and regions have cancelled the "seal the country, seal the city" and other related security measures, and the letter of credit as the most mainstream one of the payment methods, accordingly, faces new challenges. In this regard, how to locate the risk as soon as possible, identify the risk, and do well corresponding prevention and response are essential. This article will analyze the use of letter of credit in the actual international trade practice. Business settlement may exist risks, and put forward some specific preventive measures and countermeasures.

Keywords

COVID-19; Letter of Credit; Risk; Coping Strategy.

1. Overview of L/C Settlement Methods

1.1. Main Contents and Features of the Letter of Credit

Letters of credit play a central role in international business transactions and are opened by banks at the request of importers. A letter of credit (L/C) states that the bank will pay a certain amount of funds to the beneficiary.

Usually the exporter, after the exporter presents certain qualifying documents. The settlement of L/C mainly has the following three characteristics: First, the payment of L/C is guaranteed by bank credit, so the credit protection provided by L/C is more reliable than that of general commercial bank credit and can make financial financing more convenient. The most important is to solve the contradiction between the two sides of import and export transactions in the convection of goods and payment to a certain extent. The importer applies to the issuing bank to open the L/C, and the exporter negotiates the payment with the relevant documents stipulated. Thus, the issuing bank bears the primary responsibility for payment.

Second, as a contract between the issuing bank and the exporter, once the letter of credit is issued by the issuing bank, it is independent of the underlying sale contract. When the bank reviews the letter of credit, as long as the documents are consistent, it must fulfill the obligation of unconditional payment and is not affected by the sale contract.

Third, letter of credit, as a self-sufficiency document, takes documents as a mode of transaction. Therefore, it is a pure document transaction, and all transactions are based on the document itself, not the goods. Therefore, when the bank reviews the documents, it only needs to check whether the documents are consistent, but the specific goods transactions behind the documents are not considered, and the principle of payment against documents is implemented.

1.2. The Specific Process of L/C Settlement

The letter of credit is a settlement method in which the importer delivers the payment to the bank in advance, entrusts the issuing bank to sign for the letter of credit, notifies the

reimbursing bank of the receiving unit in the other place and forwards it to the exporter. After the exporter delivers the goods according to the conditions stipulated in the contract and the letter of credit, the negotiating bank pays the payment on behalf of the importer immediately. The specific process is as follows:

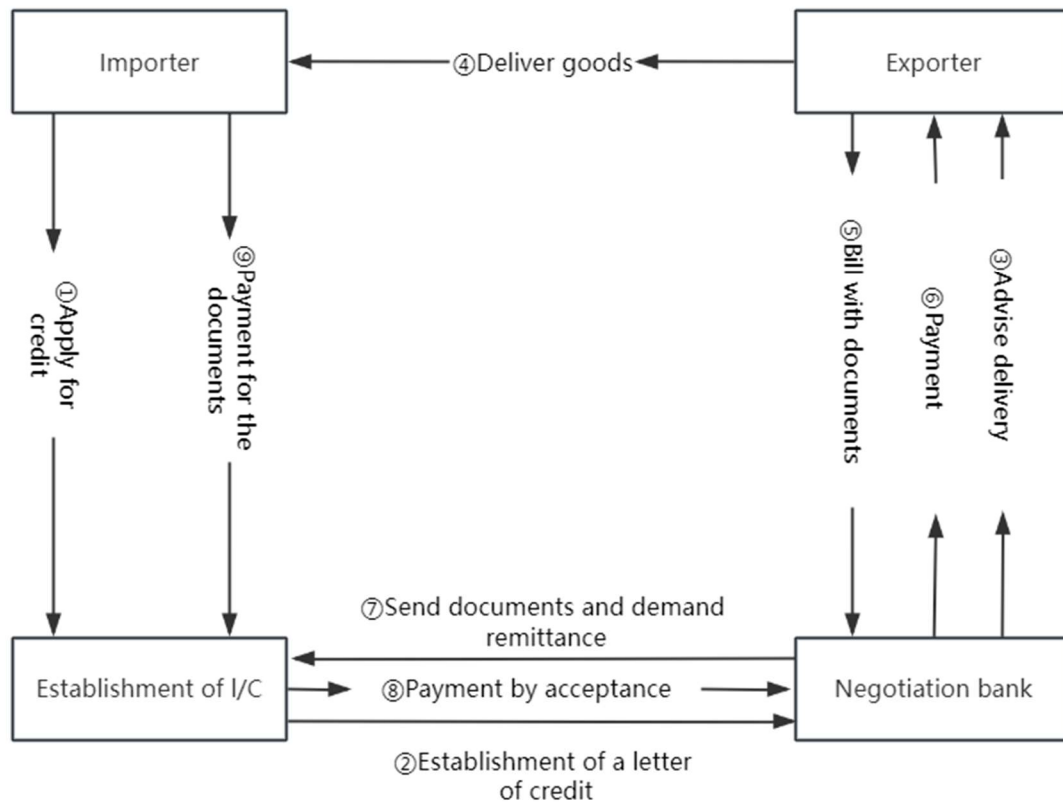


Fig. 1 Flow chart of L/C settlement

1.3. Looking at the Current Status of China's L/C Disputes from Big Data

1.3.1. Geography

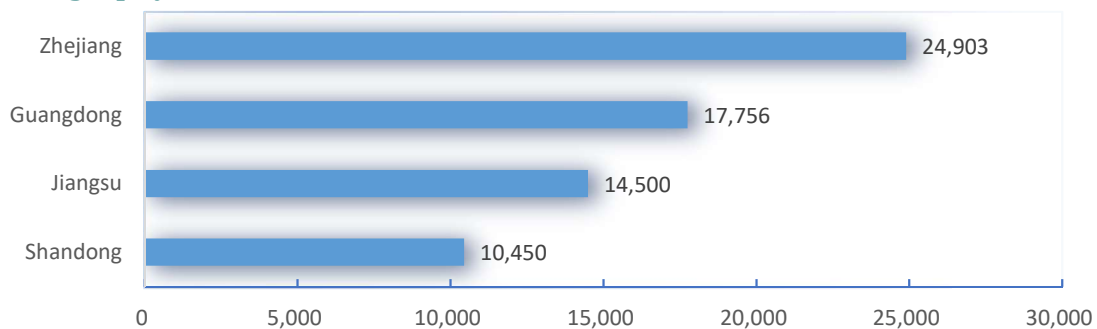


Fig. 2 Geographical distribution of major L/C disputes in China from 2020 to 2021 (Data source: Statistical collation of ICOURT-ALPHA database from 2020 to 2021)

From the geographical distribution of the cases in the above four provinces from 2021 to 2021, more than half of the cases are occupied by Zhejiang Province, which is consistent with the characteristics of economic development in Zhejiang Province. Half of the country's foreign trade has always been occupied by Zhejiang Province, so the situation of L/C disputes is far greater than that of other provinces.

1.3.2. Outcome of Litigation

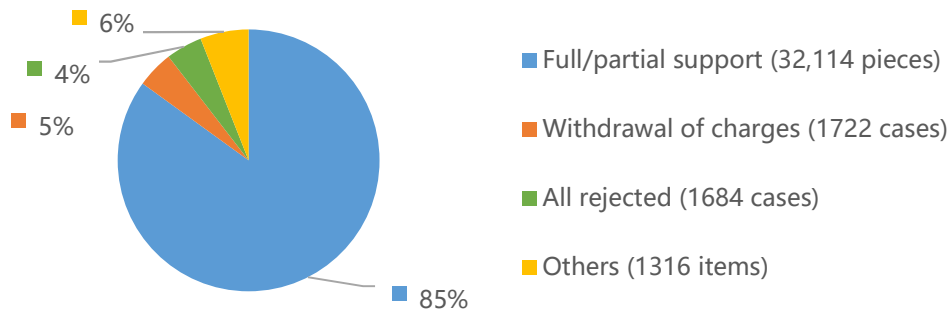


Fig. 3 Litigation results of LC disputes in the above four provinces from 2020 to 2021
(Data source: Statistical collation of ICOURT-ALPHA database from 2020 to 2021)

As can be seen from the pie chart analysis, a large part of the cases received "full or partial support", which accounted for 85%, accounting for a large part of the overall number. At the same time, the complainant (plaintiff) accounts for the vast majority of the total number of banks, including issuing bank, examining bank or negotiating bank. It can be seen that the bank is in an absolute advantageous litigation position in the litigation of "letter of credit dispute".

1.3.3. Target amount

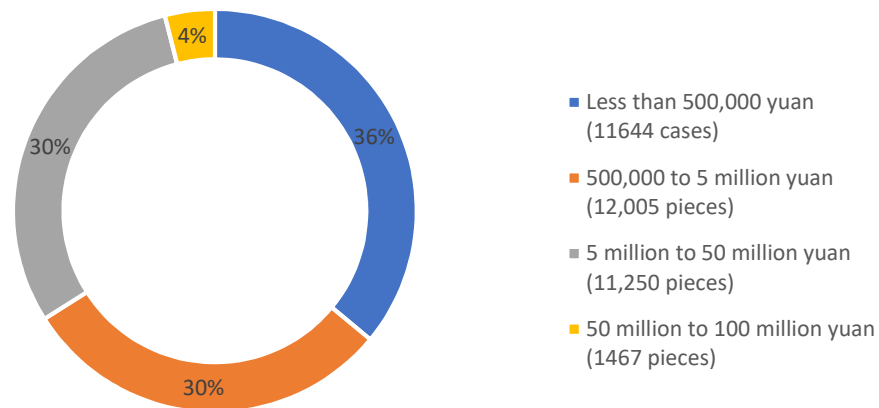


Fig. 4 Distribution of subject matter of LC disputes in the above four provinces from 2020 to 2021
(Data source: Statistical collation of ICOURT-ALPHA database from 2020 to 2021)

Based on the investigation of big data, the target amount of all cases can be set to a reasonable range between 500,000 yuan and 100 million yuan, and the currency is RMB. Therefore, it can be seen that the letter of credit disputes, the subject matter of its related cases is generally high, the upper limit has reached tens of millions of yuan, and even the lower limit has chosen 500,000 yuan file to start.

1.3.4. Industry Distribution

From the perspective of industry distribution, it is concentrated in three fields: finance, wholesale and retail, and manufacturing. It also occurs in other fields, and the number is relatively small.



Fig. 5 Distribution of L/C disputes in different industries in the above four provinces from 2020 to 2021

(Data source: Statistical collation of ICOURT-ALPHA database from 2020 to 2021)

2. Risk analysis of L/C Settlement

2.1. Credit Payment Risk Overview

If divided according to the main participants, the main body of the letter of credit can be divided into: the importer, that is, the letter of credit applicant; The payment risks faced by the exporter, that is, the beneficiary of the letter of credit, and the bank including the issuing bank and the negotiating bank are mainly as follows:

2.1.1. For Importers

(1) Letter of credit fraud: letter of credit fraud means that the beneficiary (exporter) of the letter of credit knows that there is no goods or poor quality and cannot be delivered, but still maliciously collude with others and forge one or more documents that meet the provisions of the relevant letter of credit to defraud the payment for goods under the letter of credit. For the importer, they can not get any valuable goods or no goods, but they need to bear the responsibility of payment to the issuing bank, and eventually get the consequences of losing both money and goods.

(2) No single delivery of goods: this situation is generally caused by the carrier's subjective intent or no malicious negligence, without checking the "right to carry the goods", the wrong delivery to the right to carry the goods. In the end, the importer cannot receive the goods on the one hand, but on the other hand, the issuing bank is required to pay it or claim compensation from the exporter.

(3) Quality of goods: In practice, the exporter has sent the goods, the cargo ship has sailed on the ocean, at this time only in the other side of the ocean importers, complete the delivery of goods, customs clearance, inspection and other relevant procedures, can make a more accurate judgment on the quantity and quality of the goods. So if there is shoddy, wrong version of the goods, due to the long distance, importers are forced to choose to compromise or initiate very costly cross-border litigation or arbitration in order to defend their rights.

(4) Goods Demurrage: Goods demurrage means that due to a variety of reasons, the importer can not pick up the goods on time according to the specified time, resulting in a huge demurrage. It is generally collected by the port area of the destination port. Generally speaking, after the arrival of trade goods in Hong Kong, there is a period of free parking, once the free parking time is exceeded, it will start to charge additional high demurrage fees. Even if the subject of the demurrage liability is verified, it may not necessarily be the importer's responsibility; However,

if the importer can pick up the goods as soon as possible to complete the downstream sales of the supply chain, it usually chooses to pay the payment for goods and demurrage charges.

2.1.2. For Exporters

(1) The letter of credit is inconsistent with the trade contract: in the actual situation, the exporter will dispatch and prepare the document according to the draft letter of credit, but when the formal letter of credit is received, it is different from the terms of the trade contract concluded at the time of communication and negotiation. At this time, the exporter should actively communicate with the importer, ask the importer to re-open the L/C or request the issuing bank to send swift telegram, and modify the L/C in time. Otherwise, there will be inconsistent documents, which will eventually lead to the failure to negotiate the payment.

(2) Soft terms of letter of credit: Strictly speaking, "soft terms" are not formal legal terms, but more like a conventional dialect. Soft clauses are also called "Pitfall clauses". It is relatively common in real practice. Usually can be divided into several types: first, inconsistent type; Second, semantic ambiguity; Third, uncontrollable factor type. This kind of initiative is in the hands of the importer, and it is difficult for the exporter to grasp or try to reach the terms, which is very passive for the exporter.

(3) Letter of credit fraud and alteration: Even if the letter of credit swift telegram is issued through the SWIFT system, it cannot be ruled out that there are some illegal space for letter of credit fraud or alteration. If the exporter makes relevant documents according to the letter of credit that has been falsified or altered, it is very likely that the payment for goods will not be received in the end.

(4) Issuing bank late payment or non-payment type: Because there is a big gap between the credit and performance capacity of banks in different countries, it is more necessary to adjust the international credit rating of relevant banks accurately. Exporters will also face huge losses if they encounter issuing banks with low credit ratings that are unwilling or unable to pay.

2.1.3. For Banks

In the process of L/C settlement, the bank's role in L/C payment is mainly to (1) accept the application of the applicant and open the L/C, (2) examine whether the documents provided by the beneficiary are consistent, and (3) bear the responsibility of primary payment. In letter of credit payment, whether the documents are consistent is the only basis for the bank to judge whether the payment should be made to the beneficiary. However, in international trade transactions, it is very simple to forge a document. For those forged documents, if the bank cannot identify their authenticity but negotiates the payment to the exporter, it is very likely to face the risk that the importer will refuse to pay the payment due to the receipt of goods inconsistent with the trade contract.

2.2. Main Risks of L/C Settlement

2.2.1. The Epidemic Caused the Business Interruption of the Issuing Bank, and the Payment was Finally Due

When the import and export parties settle by L/C, if the issuing bank has accepted the payment, it is equivalent to determining the payment obligation of the issuing bank. Therefore, if the issuing bank is within the validity period of the L/C and conforms to the principle of single and consistent documents, the issuing bank shall fulfill the payment obligation. However, due to the impact of the epidemic, when L/C is used for the settlement of import and export trade, the bank has been suspended when the exporter presents the document, resulting in the normal acceptance of the L/C. Moreover, it is unknown when the epidemic will end, when the issuing bank will be able to operate normally, and whether the issuing bank will eventually go bankrupt in the epidemic, so exporters will face the risk of delaying payment for goods and even bank bankruptcy. If the issuing bank cannot operate normally, nor can it submit documents to the

importer in accordance with the contents stipulated in the letter of credit, the importer can not normally withdraw the goods on time, which may bring great economic losses.

2.2.2. The Epidemic Causes the L/C to Expire, Resulting in Discrepancies

The negotiating bank shall deliver the L/C to the issuing bank when sending the document claim to the issuing bank, and the issuing bank shall show that the L/C has been signed. However, due to the impact of the epidemic, the issuing bank has suspended its business, resulting in no one reviewing the documents. It is not known whether the issuing bank can accept the letter of credit, and the issuing bank may still be unable to resume its business after the expiration of the letter of credit. After the issuing bank resumes business, it will no longer negotiate the letter of credit that has expired due to discrepancies. In this case, the initiative is mostly in the hands of importers and banks. At this time, if the importer deliberately sets up the relevant hidden "trap" clause, the exporter will be in a very passive situation, the importer and the issuing bank can at any time on the grounds of "inconsistency", exempt from its payment responsibility.

2.2.3. The Epidemic Affected the Transportation of Goods and Delayed Documents

When the import and export parties settle by L/C, due to the impact of the epidemic during the transportation process, the transportation company shipped the goods without obtaining relevant documents in order to book cargo space quickly for shipment; or due to the impact of the epidemic, the freight forwarding company could not successfully book cargo space for shipment of trade goods, so that the relevant documents could not be obtained and the documents could not be submitted. It is unable to complete the documents presented under the L/C and therefore cannot negotiate.

2.2.4. The Pandemic Increases the Risk of Fluke, Inertia and Recklessness

In the actual import and export trade, the import and export sides often have a very close cooperative relationship. Before the epidemic, there may have been transaction records of letters of credit with "discrepancies", and the issuing bank can accept the discrepancies and negotiate the payment, so it still continues to deal with luck when the epidemic breaks out. In this case, payment is likely to be refused due to the same discrepancies in the L/C as before. The epidemic may make the risk of fluke psychology, inertia psychology and careless handling of problems of LC participants be infinitely amplified, and finally make them suffer huge economic losses during the critical period of the epidemic.

2.2.5. The Epidemic Makes the Settlement of L/C Impossible

When L/C is used for the settlement of import and export trade, due to the impact of the epidemic, the bank has been suspended when the exporter presents the document, resulting in the normal acceptance of the L/C. The importer is likely to demand telex release of the goods before fulfilling the payment obligation under the letter of credit on the grounds that the goods are urgently needed. If you agree to the requirements of the importer, first telex release the goods and then fulfill the payment obligation, the exporter will face a huge risk of losing the control of the real right and receiving the payment.

2.3. Legal Analysis Related to LC Settlement Risk

2.3.1. Determination of Force Majeure

Article 36 of UCP 600 defines force majeure as: The Bank shall not be liable for the consequences of interruption of business caused by acts of God, riots, riots, insurrections, wars, acts of terrorism or any strike, lockout or any other cause beyond its control. When banks resume business, they shall not accept or negotiate letters of credit that have expired during the period of interruption. The first half of the sentence does not list an epidemic, but whether the "any other cause" in the second half includes an epidemic is controversial, so it is difficult to find an accurate answer to this question from the UCP 600. Therefore, the International Chamber of Commerce has issued a special guidance document on this issue and made relevant

explanations. In the ICC Force Majeure and Hardship Clause, "Force majeure" has a more specific definition: when a party performs several obligations under the trade contract, there are circumstances or events that prevent or hinder a beneficiary of a party, and the beneficiary affected by the obstruction or obstruction must prove that there are three circumstances: First, the hindrance is beyond the reasonable control of the beneficiary; Second, at the beginning of the conclusion of the trade contract, the obstacle could not be foreseen; Finally, after the parties are affected by the obstruction, they cannot reasonably eliminate or avoid the results brought by the obstruction. The document clearly stipulates that "force majeure" specifically includes epidemics, natural disasters, plagues or extreme natural events, so the COVID-19 epidemic should be force majeure.

The International Chamber of Commerce advocates that banks should try their best to overcome difficulties and adopt other alternatives to fulfill their due obligations, rather than abuse force majeure to relieve their responsibility for payment. For example, during the outbreak of the epidemic, banks can use telecommuting, working at home and taking turns to overcome the obstacles caused by the epidemic, and should try their best to provide customers with normal basic services. However, if the bank does not suspend its business, but due to the inconvenience of transportation or the reduction of relevant staff and other obstacles that could be overcome eventually cause difficulties in business, it does not constitute force majeure but can only be regarded as a difficult situation.

2.3.2. Liability for Delay Or Loss of Documents

Paper documents are considered by the International Chamber of Commerce to be the lifeline of international settlement, which shows its great significance. However, during the epidemic period, the poor delivery of paper documents has a very serious impact on trade settlement, making it difficult to proceed smoothly, which is especially obvious in the LC business with documents as the core. Article 35 of UCP 600 clearly states that when the relevant documents are sent as required under the credit or in the absence of instructions from the credit, the bank shall not be liable for the consequences of delay, loss, imperfection or other errors in the delivery of the documents if the bank chooses the delivery service at its own discretion. Because the express delivery business is basically suspended during the epidemic, it will lead to the normal delivery or collection of documents. In this regard, in the "Correct understanding of UCP 600 Article 35 first paragraph of the interpretation document" issued by the International Chamber of Commerce mentioned: UCP 600 Article 35 also applies to the closure of the Courier company can not send or receive the normal situation, after making reasonable efforts and timely notify the issuing bank, the designated bank can be exempted. But the most important question is: Is the issuing bank obligated to pay? This is actually related to the terms in the content of the letter of credit. The results may be very different due to the different places of withdrawal and the different payment obligations of the issuing bank. As far as the importer is concerned, the L/C should be opened as far as possible at the counter of the issuing bank for negotiation. However, for exporters, they should strive to obtain that the place of payment from the importer is the bank where the exporter is located, and they can negotiate freely. Under normal circumstances, there is no obvious difference between the two choices, but in the case of an epidemic, if the delay or loss of the delivery of documents eventually leads to disputes or lawsuits, the advantages and disadvantages of the two will be highlighted.

3. Coping Strategy and Enlightenment of LC Settlement Risk

3.1. Countermeasure Analysis for the Above LC Settlement Risks

3.1.1. Pay Close Attention to the Dynamics of the Issuing Bank and Do a Good Job in Coordination

When the epidemic makes the issuing bank unable to operate normally, the exporter should promptly and accurately understand whether the actual situation in the country where the issuing bank is located is serious. Once it is known that the issuing bank has resumed normal business, the exporter should contact the issuing bank in time to urge the issuing bank to negotiate the payment as soon as possible. At the same time, if the goods are demurrage, it is likely to produce demurrage charges. In order to avoid disputes and damage, flooding or loss of goods while demurrage occurs, exporters should take the initiative to negotiate with importers, freight forwarders and other related issues such as transportation costs, shipment dates, demurrage charges and finally reach an agreement.

3.1.2. Strictly Review Documents to Prevent Discrepancies in Documents

As stated above, the COVID-19 pandemic is force majeure and issuing banks will no longer negotiate or accept letters of credit that are overdue due to suspension of business during the pandemic when they resume business. In this case, discrepancies will occur directly under the expired L/C documents, the bank's guarantee liability will disappear, whether the payment is entirely up to the importer's will, and the exporter has the risk of collection. Therefore, the documents should be strictly reviewed and corrected in time if discrepancies are found. Before export, in view of the possibility of discrepancies, try to get the importer to make a written proof of payment within a certain period after receiving the goods. In case of any discrepancy in the letter of credit due to the above epidemic situation, the exporter shall promptly communicate with the importer and request it to amend the letter of credit; If the goods have been shipped, the importer should be contacted in time to accept the discrepancy and strive to seize more initiative.

3.1.3. Fully Understand the Situation and Take Preventive Measures in Advance

The delivery of documents is delayed due to problems in transportation, etc., resulting in the documents not being delivered to the issuing bank on time, and the overdue letter of credit is deemed to be a discrepancy. When encountering such situations, the parties need to fully understand the situation before making appropriate shipment arrangements, and can also make specific transaction adjustments in advance, and real-time monitoring of high-risk areas, and take preventive measures in advance for problems such as low efficiency and poor supporting facilities. Exporters should be fully informed, especially in situations of extreme uncertainty about the impact of the pandemic. If the shipment time meets the requirements of the letter of credit, its validity period is reasonable, partial shipment is allowed or transshipment is not allowed, the possible impact of the spread of the epidemic should be considered and room should be left. Exporters also need to pay attention to the control of goods rights, it is best to choose the way of sea transportation, because the air waybill can not be used as proof of real right, choose CIF, CFR and other trade terms, and try to choose their own freight forwarding company, so that even if there are risks in the future, exporters can appoint freight forwarders to deal with the goods will be much more convenient.

3.1.4. Be Careful to Deal with Old Customers + L/C Discrepancies

Now in the context of the epidemic, the economy of the importing country is stagnant, sales are slow, and the import commercial letter of credit has discrepancies and reasonable refusal to pay for goods, such as such old customers + letter of credit discrepancies need to pay more attention to prevent the luck and inertia of not paying attention in time, and reckless treatment eventually leads to loss of interests. Such risks can occur at any time and are magnified in the

context of the pandemic. Therefore, it is necessary to fully understand the risks that may occur under the letter of credit, timely ask professionals to give correct guidance when risks occur, and if necessary, take out insurance to reduce losses.

3.1.5. Conclude a New Contract to Avoid Loss of Ownership Control

If the settlement of letter of credit is affected by the epidemic and cannot be used normally, the exporter will lose the control of property rights and the letter of credit will lose its function, and the risk has actually been transformed into credit sales. In case of sudden need to change the settlement method, the parties shall cancel the letter of credit in writing and conclude a new trade contract and then discuss the new settlement method. We must not easily and blindly lose the real right control of goods, resulting in huge economic losses.

3.2. Implications for LC Settlement Risks in the Post-epidemic Context

3.2.1. The Process of Digitization of L/C Settlement Should be Accelerated

With the impact of the COVID-19 epidemic, the deficiencies of the paper document trading system have gradually been exposed. The policies of various governments to seal off countries, cities and flight bans have made paper document transactions more inefficient and difficult, and the trade method based on paper documents has become obsolete and will not be used any longer. In order to accelerate the transformation of paper trade documents into digital electronic documents, governments, international chambers of Commerce, and transnational trade workers should promote the updating, mutual cooperation, timely amendment of relevant legal provisions and improve the legal framework, and strive for the recognition of digital electronic documents by relevant laws of governments or jurisdictions. It enables more fair cooperation and dialogue between countries, regions and banks, and ultimately makes the electronic platform widely recognized by both import and export trade parties, government agencies of the two countries, freight forwarding companies, financial banking institutions, etc. At the same time, the scale of digital platform is further expanded, multiple counterparties are connected through standardized platforms, and the application of blockchain, document digitization, automated document delivery and processing software is accelerated, so that the digitalization of documentary trade settlement has entered a stage of rapid development.

3.2.2. A Risk Crisis Management Mechanism Should be Established

The sudden attack of the epidemic has brought great challenges to the settlement of import and export trade based on paper documents, especially the settlement of letters of credit, which is most closely related to documents. Therefore, when encountering an unexpected crisis, it is necessary to respond more actively and face up to the risk crisis. It is necessary to predict the occurrence of risks in a timely and comprehensive manner, effectively control the development process of risk crisis, real-time monitoring of risk crisis, and timely sorting out after occurrence. Information on the risk of outbreaks needs to be collected proactively and quickly. Information such as "closed country", "closed city", "local banks suspended business", "express delivery company suspended", etc., to make a comprehensive assessment of the impact of the epidemic on the business, and timely make business alternatives, and quickly do a good job of risk crisis assessment, record and approval. Strengthen crisis warning and timely communication with trading partners to prevent transaction failure due to information asymmetry. Strictly sort out the problem of risk crisis, formulate a comprehensive risk plan, and provide guarantee for the smooth completion of trade business.

3.2.3. A Digital Risk Control System for L/C Settlement Should be Established

The novel coronavirus epidemic has made commercial banks in various countries push contactless financial services to a boom, and the digital transformation of paper documents to provide contactless financial services to trading partners has become a new direction for commercial banks to compete. In the environment of fierce competition among various

financial technologies, technology, transaction and other risks as well as related non-financial risks are intensified. Coupled with the frequent use of financial technologies such as big data, Internet of Things, blockchain and cloud computing, there is a risk of exposing a large amount of data privacy in this process. Therefore, in order to reduce financial risks, it is necessary to better protect relevant data privacy. Secondly, with the rapid development of digitalization of commercial banks, banks have gradually improved relevant processes and systems, strengthened the institutional support of new trade business models, and paid more attention to the use of relevant international practices such as EUCP (UCP Electronic Presentation Supplement) in digital trade settlement. Build a new risk crisis prevention and control system and strengthen the risk crisis prevention of digital trade mode.

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