

The documentary credit: strict compliance and its limits

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The documentary credit is the central instrument of commodity trade finance, issued, confirmed and examined every day by banks in Geneva. Its strength lies in the rule that the bank pays against conforming documents alone. This article explains how the instrument works, how Swiss courts apply the rule of strict compliance and what the trade finance frauds of 2020 revealed about its limits.

1 How the instrument works

Under a documentary credit, or letter of credit, the buyer's bank undertakes to pay the seller, or to accept bills drawn by the seller, against presentation of documents that comply with the stipulated terms within a set period. The seller thereby obtains a bank's commitment that is independent of the buyer's solvency. The buyer, for its part, obtains assurance that payment will only be made if the documents prove shipment of conforming goods. Five parties may be involved: the applicant who asks its bank to issue the credit, the issuing bank, the beneficiary who presents the documents, an advising or confirming bank on the seller's side and, where needed, a reimbursing bank.

A typical presentation includes the bill of lading issued by the ocean carrier, the commercial invoice, an inspection certificate, a certificate of origin, an insurance policy or certificate and customs documents. Confirmation by a second bank, usually the seller's bank, adds that bank's own undertaking to the issuer's. It protects the seller against default of the issuing bank and against the country risk of the buyer, which matters in trade with countries whose banks are fragile. Geneva banks accordingly confirm many credits issued by banks in producing countries, then seek reimbursement from the issuer, which releases the documents to the buyer against payment.

Documentary credits are governed by the ICC Uniform Customs and Practice for Documentary Credits, 2007 revision (UCP 600), in force since 1 July 2007. That revision reduced the text from 49 to 39 articles and introduced sections on definitions and interpretation. Article 7 sets out the undertaking of the issuing bank and Article 8 that of the confirming bank, while an eUCP supplement covers electronic presentation. Guarantees and standby letters of credit follow separate rules: the ICC Uniform Rules for Demand Guarantees (URDG 758), adopted on 3 December 2009 and in force since 1 July 2010, and the International Standby Practices (ISP98).

2 The rule of strict compliance in Swiss law

Swiss law has no specific statute on documentary credits. It reaches the instrument through trade usage and the law of mandate in the Code of Obligations (CO). The Federal Supreme Court addressed the question in judgment 4C.393/2005 of 9 November 2006, discussed by Nicolas de Gottrau in a note of 16 January 2007 for the Centre for Banking and Financial Law (CDBF). The bank had only to verify the formal regularity of the documents and their conformity with the terms of the credit. Documentary strictness is the rule, the court held, with an exception only for an irregularity so insignificant that it could in no case cause harm. In that case a document issued by "XYZ srl" was rightly refused because the credit required one issued by "XYZ spa".

The rule also protects the applicant against its own bank. In judgment 4A_488/2008 of 15 January 2009, discussed by Samuel Zemp in a CDBF note of 24 February 2009, the Federal Supreme Court dealt with a standby credit subject to the earlier UCP 500. Because the issuing bank had paid in breach of the principle of documentary strictness, it was refused reimbursement under Articles 398(2) and 402(1) CO. A bank that pays against discrepant documents therefore bears the loss itself.

The practical consequence is a high rate of rejection. A date, a quantity or a spelling that departs from the credit entitles the bank to refuse payment, which exposes the seller to a buyer who may prefer to walk away when prices fall. Trade Finance Training estimated on 23 December 2024 that between 60 and 75 % of documents are refused on first presentation, with regional variations. Under UCP 600 the bank has five banking days to examine a presentation.

3 What strict compliance cannot catch

The principle of independence cuts both ways. Because the bank pays against documents that appear to conform, without regard to performance of the underlying sale, it is exposed to well-executed forgeries. Bills of lading that circulate in several originals, and cargoes sometimes released against letters of indemnity without presentation of the bill, weaken the instrument further. Swiss law gives the holder of a document of title real security: under Article 902(1) of the Civil Code (CC), pledging securities that represent goods creates a lien over the goods themselves. That security is only as good as the document on which it rests.

The frauds of 2020 showed the cost of that weakness. When oil prices collapsed in the spring of 2020, several traders based mainly in Singapore failed and revealed that the same cargoes had been financed several times or had never existed. According to Bloomberg, as republished by AJOT on 23 September 2020, the scandals caused more than 9 billion dollars in potential losses for lenders. Bloomberg reported on 7 September 2020 that ING accused Agritrade of using overlapping shipping lists to obtain financing from several banks on the same cargo. Around eighteen banks faced combined losses of 670 million dollars in that case alone. The same report stated that HSBC accused ZenRock of using the same cargo for several loans, with banks claiming 166 million dollars. At Hin Leong, the founder disclosed 800 million dollars of undeclared losses and the sale of oil pledged as collateral, as *Global Trade Review* reported on 12 August 2020.

4 How the market responded

Banks that remained in the business demanded original bills of lading, verified documents with their issuers, commissioned independent stock inspections and compared information with other lenders. In Singapore, the Association of Banks launched a Code of Best Practices for Commodity Financing on 30 November 2020, drawn up by 28 banks with the support of the Monetary Authority of Singapore. *Global Trade Review* reported on 23 June 2023 that the association's Trade Finance Registry had gone live to eliminate duplicate financing. Switzerland subjects the activity to ordinary banking supervision without specific rules. Whether a register of pledges over goods should be created to prevent multiple financing is still an open question.

Electronic documents address the problem of multiple originals. The UNCITRAL Model Law on Electronic Transferable Records, adopted on 13 July 2017, requires a reliable method to establish exclusive control of the

record. In England, the Electronic Trade Documents Act 2023 received royal assent in July 2023 and gives electronic bills of lading legal recognition, as Kennedys noted on 20 July 2023. Wider use depends on adoption by carriers, traders, banks, insurers and port authorities, and on recognition of the legal effect of such records across jurisdictions.

5 What to take from it

The bank pays on paper. Under UCP 600 and Swiss case law, the bank examines only the formal conformity of the documents, so that even minor discrepancies justify refusal.

Strictness cuts both ways. The Federal Supreme Court refused reimbursement in 2009 to an issuing bank that had paid against non-conforming documents, so laxity falls on the paying bank.

Conforming documents can still be false. The 2020 frauds exploited documents that looked compliant, which is why verification with issuers, registries and electronic records have become the main defences.

6 Sources

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