

THESIS

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GENERAL UNDERSTANDING OF THE STANDBY LETTER OF CREDIT

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Introduction

The goal of the material is to gain a general understanding about the Standby Letter of Credit, which is a commonly used financial instrument in the United States of America. Shortly, as well as in Europe, in the 20th century the United States faced several changes in rules and regulations regarding the bank sector, however the appliance of the Standby Letter of Credit has never been restricted by their law. Today, the SBLC is one of the most used instruments in international trade transactions.

The reading consists of 4 main chapters, chapter 1 concentrates on general knowledge of the instrument such as popularity, history, as well as differences between the SBLC and other documentary trade products. Chapter 2 provides knowledge about the different types of the SBLC. Chapter 3 offers a broad explanation of the main rules and regulations governing the instrument, and the last chapter presents specific cases, which actually happened throughout history, where there were negative outcomes of appliance of the SBLC.

Secondary research methodology was applied, meaning already existing data was interpreted. Specifically, the SBLC is still a quite misunderstood financial instrument in international trade, meaning in practice negative outcomes can occur via misinterpretation and lack of general knowledge behind the instrument. The sources applied for this material are quite limited, however genuine. With the use of the secondary data of the material, the reader gains the ability to answer the following research questions:

- a.) What are the main characteristics of this specific financial instrument to gain knowledge about, in aim for an everyday person to confidently enter an SBLC deal?
- b.) How can the trustworthiness of the instrument be evaluated by, furthermore how does certain cases and misunderstandments cause potential changes in the governing ruleset applied for the instrument?

I. Defining Standby Letter of Credit

The term of Standby Letter of Credit (thereafter) refers to the SBLC is a commonly used financial instrument in international trade. The most famous label used for this instrument is called „payment of last resort“, referring to one of the main feature of the SBLC. The basic concept

of the SBLC is closely related to the Bank Guarantee, where the main goal is protection of the involved parties from defaults either in financial obligations or performance.

■ The most basic example, where the Standby letter of credit is the most efficient instrument to choose would be the following:

- From the perspective of the buyer: Where performance (quality of work, keeping time schedules...etc) is relied on heavily, usually buyers of large projects.
- From the perspective of the seller: When assurance of payment is needed.

■ The definition of SBLC by their global rule:

„The global rule sets which govern standby letters of credit (SBLC) - both the Uniform Customs and Practices current revision 600 (UCP 600) and International Standby Practices current revision (ISP98) - define a SBLC as an undertaking. An undertaking provides the named beneficiary with an “independent” assurance of payment from the undertaking’s issuer (issuers are most often banks).” (Internet 1)

After understanding the basic concept of the Standby Letter of Credit, now the history, moreover the birth of the instrument is examined in chapter.I.1.

I.1.History of Standby Letter of Credit

The birth of the Standby letter of Credit can be traced back all the way to 1933, when the „Great Depression” in the United States just ended, the Glass-Seagall legislation was introduced in the same year.

The bill was signed by President Roosevelt shortly after getting his role as a president of the United States. The aim of the bill was mostly to restore confidence in the banking system of the United States, the main element of the act was the separation of commercial and investment banks. At the start of the „Great Depression”, in 1929 US government realised that due to volatile equity markets commercial banking operations and payment systems were incurring losses.

The separation of the commercial and investment banks meant various changes in each type of banks everyday activity. Commercial banks were no longer able to underwrite or deal with securities, investment banks who could, on the other hand could not keep a tight relationship with commercial banks anymore. Institutions had one year to decide whether they specialize in the direction of investment or commercial banking. The most important criteria was that a

maximum of 10% of the income of commercial banks could stem from securities. The exception was the ability of commercial banks to underwrite government issued bonds.

The act included a restriction on US banks from issuing guarantees with secondary liability, in cases where another party's default or debt has to be paid or secured. As the standards of business grew, banks and agencies needed to introduce a financial instrument to solve barriers and meet demands in international trade. An instrument was needed very similar to the Bank Guarantee, where the presentation of necessary documents or just by a simple demand the guarantee comes into effect. This was the main motivator in the foundation of the Standby Letter of Credit. The basic concept of the Bank Guarantee and SBLC is very similar, both operate under the principle of independence and strict compliance.

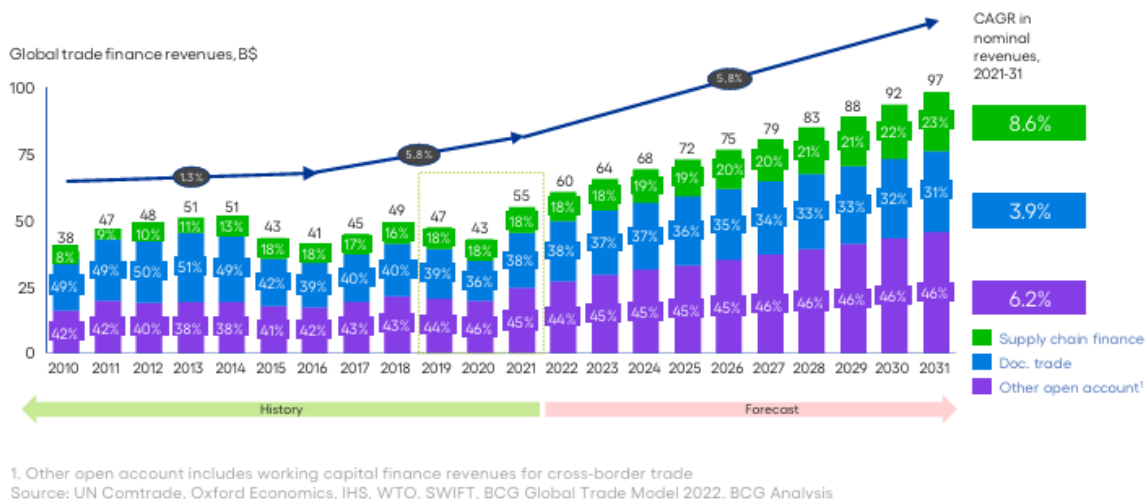
I.2.Popularity of SBLC-s

The Standby Letter of Credit is considered to be revolutionary in terms of facilitating confidence in international trade deals. It is characterised to be flexible in customisation of contractual terms, making it transferable. Most importantly a securable, as well as reliable method of payment in international transactions today.

Especially, in the industrial sector, where contracts are in effect on a longer-term, the use of SBLC-s provide security, mitigates political and currency risks, as well as offer flexibility to negotiate favourable contract terms for both parties.

SBLC-s today are used in different types of banking and business practices, for instance when appeal bonds are issued, surety companies accept SBLC-s in lieu of collateral. In virtual power purchase agreements, SBLCs are used as a safeguard against project delay risks, due to being used as synthetic letters of credit.” Insurance companies use SBLCs to secure insurance premiums, and, in some cases, posting an SBLC is a state-mandated requirement.” (Prasad,2024)

As being a financial instrument, the revenue generated by the use of SBLC-s is a great indicator of how popular the instrument actually is. According to the BCG Global Trade Model of 2023 58billion US dollars was generated in 2022 by trade finance ,41% of the total were by trade finance banking revenues, specifically by the use of documentary trade products, which are Letter of Credit's and Bank Guarantee's.



The ICC Trade Model of 2022 shared some interesting statistics about the volume of SBLC use. The flow of documentary trades surpassed 2,5 trillion USD. Furthermore the popularity of the use of SBLC-s has increased outside the United States, reaching 1 trillion USD in the flow of documentary trades.

I.3. Understanding why the Standby letter of Credit is considered attractive

First of all, businessmen need an instrument guaranteeing performance or financial security especially company owners dealing with large projects and/or risking very large sums of money. Second and maybe even more importantly, heads of corporation would obviously like the most cost-friendly option available, in this case the low default-rates and capital charges by the SBLC become highly attractive.

The ICC Trade Model of 2022, more specifically the credit risk profiles of trade finance, including the Standby Letter of Credit showed attractive statistical data about the instrument. According to the data in 2022, after careful examination, the obligor-related default rate was at a low of 0,26% in the year 2020. Moreover, after starting to examine the same statistic more specifically, meaning concentrating on transaction and exposure-related default rates between the year 2015 to 2020, the percentage went even lower. Drawing rates of both Bank Guarantee's and SBLC-s were estimated under a 1%.

As in any service provided by the bank to it's customer, the bank will ask for the payment of the provided services, usually in the forms of fee's. The SBLC has a fee-based income, meaning the LC-advising, processing fees...etc must be paid. This is the direct income generated from

the use of Standby letter of Credit. Furthermore, cross-selling additional products and services to customers can be enhanced by the use of SBLC-s.

As a conclusion it can be stated, the Standby Letter of Credit is an attractive financial instrument due to its low default rates and capital charges, as well as flexibility in negotiation of favourable contractual terms, focusing only on fee-based income. It is also important to mention the widespread adoption of the ICC rules and technological advancement, which contributed to the instrument gaining more popularity.

I.3.1.Basics of Evergreen clauses

In addition to the last chapter, explaining what makes the Standby Letter of Credit attractive to actors in international trade, the „Evergreen clause” is a very useful attribute of the financial instrument as well. the clause contains the following rules.

- Evergreen clauses inserted in a SBLC means that the expiry date will be prolonged for a fixed amount of time, usually six months to a yearly period.
- The applicant and/or issuer can rely on the so called „exit period” provided by the evergreen clause, meaning the expiration of the SBLC happens via a notification of cancellation by the applicant and/or issuer without the need of amendment by the beneficiary
- Usually the notification period is thirty to ninety days before the original expiry date and is inserted in the SBLC document.

I.3.2 Benefits of Evergreen clauses

The main benefits obtained from an evergreen clause are the following:

- If, the applicant is looking for a different issuer due to various reasons, mainly because of lower costs in perspective of the applicant, the exit period provided by the evergreen clause makes the cancellation process smooth.
- The amount of fees payable may be reduced as the commitment towards the bank or financial institution will be shorter than the original expiration date states.

I.4.Applying proccess for a Standby Letter of Credit

As a start, there has to be a buyer-seller relationship formed, backed by a contract of sales or performance, in the case of SBLC usually an International Contract of Sales or Performance, as the SBLC issued will be a guarantee of payment in cases of default in payment of the buyer

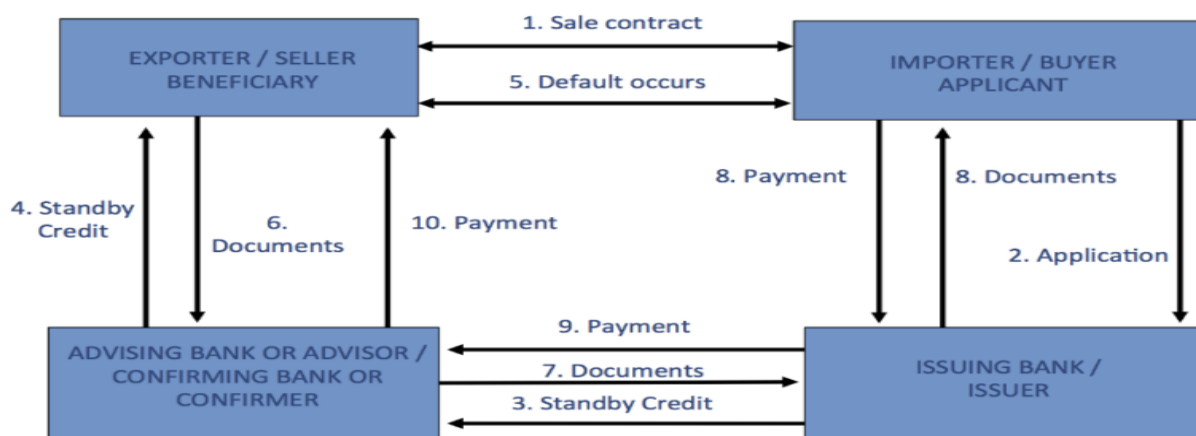
in terms of financial SBLC-s, or a guarantee of reimbursement in cases of default in performance of contractor in terms of performance SBLC-s

When it becomes clear the performance or financial obligation has to be backed up by a Standby Letter of Credit, the buyer will be the party initiating the process. The steps to applying for the SBLC are the following, using the financial SBLC as the basic concept.

- The buyer applies (usually at their bank) for a SBLC in favour of the seller (counterparty).
- The bank of the buyer (issuing or opening bank, in SBLC terminology), with „due diligence” will check the creditworthiness and financial reliability of it’s client.
- In case the issuing bank is satisfied with the application the SBLC issued will be forwarded to the seller’s bank, if there is such, or just solely the beneficiary in SBLC terms.
- The representative bank of the beneficiary checks the validity and authenticity of the issued contract.
- As per the contract, the seller will forward the goods or provide the service to the buyer.

Now after Step 5, either the obligation is completed by the applicant, meaning the product or service provided by the beneficiary is paid by them in time, the exact amount, or the applicant fails to make payment. In the scenario where the applicant cannot fulfill their obligations stated in the underlying contract, the beneficiary can draw on the SBLC, by usually submitting necessary documents to the issuing bank. Eventually the amount specified in the SBLC is paid to the beneficiary by the issuing bank.

How Standby Letters of Credit Work



The following chapters explain the benefits, risks and considerations both from the perspective of the applicant and beneficiary, as well as considerations of the issuer.

I.5.Benefits from perspective of the applicant

■ The most important in terms of business, is that the applicant, in simpler terms the buyer can secure a contract and/or a deal, which without a security like the „Standby Letter of Credit” could not obtain.

■ If, the applicants SBLC application form is satisfactory in the perspective of the issuing bank, it indicates the creditworthiness of their client. In this sense, it can be stated, successful SBLC deals are a „credit-enhancement” tool. By meeting the standards of general terms and conditions in regards of applying, paying the reimbursement to the issuing bank...etc. the applicant can obtain a high credit rating, which is significantly important.

■ Usually, there is flexibility in negotiating better contractual terms for the applicant, meaning lower interest-rates, longer period until payment is due...etc, which is of course beneficial for the applicant.

■ SBLC-s can be tailored to even solve so called „trigger events, due to its transferability.

I.6.Benefits from the perspective of the beneficiary

■ The main concept here, is by definition the „undertaking” part, meaning that the seller (in SBLC terms the beneficiary), is secured of payment by the issuing bank, even if there is a breach of the underlying contract, where the beneficiary is supposed to get payed or performance being done in quality and a timely manner. Issuance of the SBLC in favour of the seller of the underlying contract means the seller will get compensated anyways, their only duty is to draw on the SBLC and must present the necessary documents which comply with the specific SBLC terms.

■ The SBLC by nature is direct and „irrevocable”, meaning there is no way to get around paying the beneficiary by the issuing bank.

■ As SBLC-s are mostly transferable, it gives more flexibility to the beneficiary, by providing the opportunity to transfer the credit to another party.

■ The use of SBLC decreases risk in case of political instability, exchange rate fluctuations...etc

I.7.Risks in perspective of the applicant

- The applicant in certain cases can lose the SBLC amount, due to wrongful or fraudulent draw by the beneficiary. It could happen due to a breach of contract, or a misunderstanding, in plenty cases when performance SBLC-s are issued, there are disagreements on performance or quality standards.
- Opposing to the benefits, as mentioned above, credit-enhancement can occur in case of successful performance, however if problems occur with the applicants part of completing the obligation mentioned in the SBLC in the future renewing SBLC-s become more difficult, as the specific applicant's credit-rating deteriorates.

- Fees can be considered to be expensive, even though default rates and charges are relatively low as highlighted before. The issuing bank can ask for collateral or security deposits as well.

I.8.Risks in perspective of the beneficiary

- Even though the beneficiary enjoys high level security, as being the beneficiary in a SBLC deal, in tragical cases such as failure or insolvency of the issuer, payment cannot be made. Factors like liquidity problems or regulations can be the cause of such cases.
- When the beneficiary needs to draw on the SBLC, sometimes the process takes longer than expected, because of incomplete documentation, or when the documents are inconsistent with SBLC terms.
- When performance SBLC-s are issued, it might happen that not all losses and damages are compensated to the beneficiary, even though non-performance of the applicant is certain.

I.9.Main considerations to be taken in perspective of the applicant

- As mentioned in the „risks in perspective of the applicant” part before, due to even misunderstanding the SBLC can be wrongfully drafted. It means it is rather the duty of the applicant to pay attention to the compliance of the SBLC terms with their underlying contract, which is usually a Contract of International Sales. Especially, paying attention to the drawing requirements in the SBLC and what is considered to be a breach of the underlying contract, as the SBLC is independent from the underlying contract between the buyer and the seller.

„A SBLC is documentary, an issuer is not concerned with the underlying contract and will make its payment decision solely upon reviewing a beneficiary's document presentation on its face, against an SBLCs terms without seeking confirmation of fact(s), action(s) or statement(s) made

by the issuer of any document contained in the presentation.” (Internet 1) This reference provides a greater understanding about the nature of the Standby Letter of Credit.

I.10.Main considerations to be taken in perspective of the beneficiary

■ The number one priority in the point of view of the beneficiary is to make sure the credit rating of the applicant (their buyer in simpler terms) is satisfying for them, plus factors such as country and political risks are not too high.

● If, risks are considered to be high and/or there is problems with the creditworthiness of the applicant, it is advised for the beneficiary to require a so called „confirming bank”.The role of the confirmer or confirming bank, when involved in Standby Letter of Credit deals is the following:

● It officially is requested by actually the issuer, which is in SBLC deals the issuing bank.

● It becomes in a sense a secondary-issuing bank, as their role is to undertake the honoring of the complying document presentation.

● It is additional to the issuing bank’s undertaking, however the amount specified, expiry date...etc can differ in the two independent transactions.

Even though the request of a confirming bank can be useful it is still crucial to put serious attention on the first point mentioned in this chapter. The beneficiary must, referring to the same point mentioned in the chapter „I.8”, ensure the drawing requirements and wording of the SBLC and the underlying contract comply. It is very useful to keep in mind, if somebody becomes a beneficiary in an SBLC deal the following considerations:

■ Whether, necessary documentation is in alignment with the drawing requirements.

● This is crucial, as if even one complying document is missing, it means the issuer is not obligated to honor the undertaking anymore.

■ If, the requirements to demand payment are clear or not

● Misunderstandings can easily occur in instances where these reasons and statements are not addressed clearly. If, a certain demand for compensation is based on a reasoning, which has not been included in the SBLC, the same as before, the issuer is not obliged to pay in this situation.

- If, the SBLC expires in sufficient time to the underlying contract.

It is important to mention as well the advising and confirming costs may have to be paid by the beneficiary for the provided services. In case of legal dispute, the best base is to have broad knowledge in the preferred international rulesets governing the SBLC-s, which may insist in a case.

I.11.Main considerations to be taken in perspective of the issuer

- Reputational risks are highly concerned, in certain cases even one negative act by a company can make business take a downward spiral, especially in the banking and financial sector the effects are multiplied. This means the issuing bank must be aware of unpopular contracts or agreements, or of any illegal activities such as money laundering.

Getting more in depth about the Standby Letter of Credit, it comes to realization the document has many characteristics very similar to other documentary trade products such as the Bank Guarantee. However, looking into the comparison of these products, differences can be found as well. In the next chapters, the SBLC will be compared to other financial instruments.

I.12.Comparison of Commercial Letter of Credit and SBLC

- The main similarity about the two documents is that the issuer will take the applicant very seriously, in terms of examining creditworthiness, potential risks...etc
- Regarding both documents, if accepted by the issuing bank, the applicant will be obliged to pay the „issuing” or „opening” fee. However, going further in the process a big difference comes into realisation.
- When using commercial L/C-s, at least one, but usually multiple document presentations are made, each presentation means paying the issuing bank the „examination fee”. On the other hand, usually the SBLC is not „drew on”, so presentation of documents are not necessary by the beneficiary anymore, meaning there is no examination fee to pay.
- By the knowledge gained in this chapter so far, it can be concluded using SBLC-s in longer-term transactions can be more efficient for the beneficiary (especially good, if the applicant is trustworthy and known by the beneficiary) , the number one reason is simply that SBLC-s in most cases expire later than commercial LC-s, furthermore it is more cost-efficient to pay the issuing fee for the SBLC only 1 time, compared to the multiple Letter of Credit’s needed, if the applicant and beneficiary do business with eachother on a relatively regular basis.

To understand more, if the SBLC or commercial LC is preferred more in deals, other perspectives than costs should be taken into consideration, although costs are obviously one of the most important factors to consider as a businessman. The factors are the following:

■ Document presentation: By definition the SBLC, the issuer neither pays to the beneficiary nor examines presented documents, as the applicant has done their obligations already. On the other hand, the commercial LC is an independent undertaking by the issuer in settlement of the underlying contract. Due to these facts commercial LC-s are rather preferred by the beneficiary.

Commercial LC-s require the representation of various type of documents such as transporting documents, packaging lists, commercial invoices...etc. Typically, when the beneficiary demands payment, the issuing bank will honor the SBLC by paying against it, sometimes by simple beneficiary statements, but at least overall less documents need to be presented than in a commercial LC-transaction.

■ The chance for a misunderstanding or a much serious issue like fraud is definitely higher when using SBLC. Here the beneficiary can draw on the SBLC by accident or purposely on error. This topic is explained later in more detail.

■ As mentioned before, the duration of the SBLC is typically longer, by nature the commercial LC is short-lived, meaning the expiry date is usually after maximum 6 months of being issued.

Both documents have the „tenor” in it, which is very important to take into consideration as well. The term „tenor” means the time period when the complying documents presented are due for payment. The tenor is found in all LC undertakings.

Usually, LC undertakings can be paid so to say „at sight” at a reasonable time, when presented documents are labeled to be complying by the issuer. However, there is another existing type of tenor called the „time tenor”, meaning the payment will be made in a certain future date, relative to whenever the the documents are considered to be complying.

■ In commercial LC-s usually financing is needed for the trade deal to even come into existence. Here the use of „time tenor” will be the more favourable option. As SBLC-s usually do not enter the stage where document presentation is even needed, in most cases „sight tenor” will be used.

As a conclusion, commercial LC-s rather behave as facilitators of trade, and are more favoured by the beneficiary, as presenting the complying documents results in the payment of provided goods and/or services. On the other hand, SBLC-s are an internationally accepted financial

instrument, and can cover all types of different contracts or agreements, to secure a deal where the buyer and seller might not have done business with each other before. When the contractual duties of the applicant are not met, first the beneficiary will make a claim of payment against the applicant as per the underlying contract.

The term „last resort payment” was promised to be explained later in the beginning of the thesis. The term is interpreted as the following:

■ When the claim of payment is not honoured by the applicant, the beneficiary will have to collect the complying documents with the SBLC in aim to claim payment against the specific SBLC. In this sense, the SBLC acts as a payment of „last resort” for the beneficiary.

I.13.Comparison of Demand Guarantee and SBLC

■ These two products are very similar to each other, as both are undertakings, assuring the beneficiary of payment when complying documents are presented.

● Furthermore, both are independent in nature from the underlying contract, demand does not have to be examined by issuer.

■ However, the main difference relies on the governing rulesets, when DG's are in use the governing ruleset is the „Uniform Rules for Demand Guarantees” (U-R-D-G 758). Most banks require the use of „U-R-D-G 758” to guarantee knowing of responsibilities in the undertaking. In certain situations the chance of risk rises as the governing ruleset behind the instrument is not clear.

■ Defaults are mainly similar in both governing rulesets, however there are important areas where differences occur:

- Force Majeure situations;
- Document examination period and approach;
- Confirmation;
- Allowable payment tenors;
- Required notifications to an applicant;
- Governing law and jurisdiction;
- Replacing a DG or SBLC undertaking lost by a beneficiary;

- Some terminology differences e.g. guarantor versus issuing party.” (Internet 1)

Chapter.I provides a general understanding about the definition of the Standby Letter of credit, risks and benefits associated to this financial instrument, differences between the SBLC and other similar documentary trade products, popularity and history of the SBLC and the application process to a SBLC.

In the next, by number second chapter the certain type of SBLC-s will be defined and explained in depth.

II.Types of Standby Letter of Credit

In the beginning of the material, two basic example’s were given in aim to understand the basic concept of the SBLC for an everyday person who supposedly does not have knowledge about financial instruments provided by banks, in this case the SBLC. The first example refers to a financial/payment guarantee, in the second example a certain performance rate is guaranteed. The type of SBLC chosen is based on the underlying contract, as mentioned before as this instrument is commonly used in international contracts, the underlying contract is usually an International Contract of Sales.

■ The main 2 categories are in connection with what the actual guarantee is, meaning where the payment is guaranteed, it is called a financial SBLC, on the other hand where the performance is guaranteed it is called a performance SBLC.

● All other types of SBLC-s fall into these 2 main categories called, financial and performance SBLC.

Now, the two main categories can be defined.

Financial Standby letter of credit

Most SBLC types will fall into this category, the financial SBLC supports any financial obligation. This type will be requested by the seller usually, in the International Contract of Sales, usually because of not-knowing the buyer personally, meaning no experience in business with this certain buyer. Furthermore, the buyer might have a low credit rate scoring, or there is no history of the financial situation/standing of the applicant in SBLC terms. As discussed in the previous chapter, the fees can make the SBLC anyway high in costs, unfortunately in certain situations the buyer might have to provide another type of security in favour of the issuing bank, which makes the proccess in whole more costly.

On the other hand, if the applicant completes their obligations in time it can build trust with not only the beneficiary, as well as becoming established business partners, but with the issuer (usually a bank) too.

Performance Standby Letter of Credit

A performance SBLC is usually issued, to guarantee performance of the applicant usually supporting the timeliness and quality of a bigger work like construction projects. Here these two factors „timeliness” and „quality” are certainly the most important, for the project to be considered overall successful. When default occurs, meaning deadlines not being met and/or the quality of the jobs done are not meeting the standards, the beneficiary could draw the SBLC presenting the complying documents, which are stated in the SBLC contract.

■ The seller requests for a performance SBLC in the following situations:

- High value transactions
- High risk of default
- Low credit rating of „applicant” (always a factor in all types of SBLC-s).
- Non-knowing of buyer (always a factor in all types of SBLC-s)

Where the two above explained factors, timeliness and quality are the basis of the underlying contract.

As the basis of the two main categories of SBLC-s are now known, specific type of SBLC-s issued by banks can be examined in more depth, the choice is made on the basis of the underlying contract between in simple terms the seller and the buyer.

II.1. Advance payment Standby Letter of Credit

■ The advance payment SBLC is in structure different then the basic examples given in the beginning of the thesis. As per the name of this type of SBLC, it is in simple terms a security of the buyer when advance payment is made, in order to guarantee „repayment”. The term „repayment” means the delivery of goods and services by the supplier in the „advance payment SBLC. In order to understand the structure of this specific type of SBLC, the actors are characterized below:

■ The supplier: The party independent of the relationship between the buyer and the issuing bank, who will as per the underlying contract send the goods and/or services to the buyer.

- Furthermore, the supplier will request the advance payment from the buyer.

- The amount needed to be pre-paid is usually 10% of the contracted value.

- The applicant: The buyer of the services and goods, who made the advance-payment, might in case of default not receive these goods and/or services. Meaning the „buyer” needs to find a solution where they will be guaranteed of reimbursement, if they do not receive what they pre-paid for.

In this case, the buyer can apply for an „advance payment Standby letter of Credit” to ensure they will be compensated, if non-delivery occurs.

In this special situation, the applicant, who as known applies for the SBLC will take the role of the beneficiary as well, becoming both parties in the SBLC contract. When the, using the simplest term here buyer of the goods and/or services experiences default, they can make a drawing statement to the issuing bank, to be compensated for the default of the supplier, by presenting documents which comply with the SBLC contract.

- The issuing bank: As always, the financial institution (usually a bank) who confirms and issues the certain SBLC.

Other important factors are ought to be taken into consideration when applying the advance payment SBLC:

- The buyer will be compensated only a certain percentage of the advance payment.

- Profit margin or interest losses will not be compensated by the issuer towards the buyer, meaning the buyer has no choice, but to bear these risks.

Eventually, it can be stated that the risk of non-delivery by providing this security decreases, and helps international trade to facilitate as pre-payment is a common request by suppliers in international transactions. With the use of the discussed SBLC both parties are well-secured, which is a common feature of all SBLC-s.

II.2.Bid or tender-bond SBLC-s

- The Bid or tender-bond SBLC is a very commonly applied form of the SBLC, usually issued to secure construction project deals or government tenders. Here the party who requests the tender or the bid needs ensurement that the bid will be „honoured”, meaning the required performance bond will be provided by the successful bidder and will be ready to enter into the

contract. To understand more, just as in the chapter „Advance payment of Standby Letter of Credit” the roles of the involved parties are explained:

■ Person/institution who requests tender or bid: In SBLC terms the beneficiary, in case of default, by presenting complying documents this party is able to draw on the SBLC.

● The amount compensated is a certain percentage of the contract value, depending on the terms of the bid request, usually a portion of the whole project value.

● To avoid misunderstandings, it is important to pay attention to the terms of the bid request and the Bid Bond SBLC to be in alignment.

■ Successful bidder: The person/organisation which wins the bid, their duty is to enter the contract and provide the performance bond. Applying for a bid-bond Standby Letter of Credit” will enhance the chance of the applicant to become the one who wins the bid, because the beneficiary is provided security by the SBLC issued. It is a great indication of readiness from the part of the applicant to honor the bid request.

■ The issuing bank: As always, the financial institution (usually a bank) who confirms and issues the certain SBLC.

Key conclusions consist of a decrease in risk of default, as well as a decrease in an unreliable bidder winning the contract. Furthermore, when the obligations are well-performed by the applicant in SBLC terms, positive effects in regards of reputation occur, meaning a higher chance of winning future bids, as well as building a strong relationship with the party requesting the tender or bid.

II.3.Clean Standby Letter of Credit

■ In the case the SBLC is considered clean, the document can be drafted without supporting statements made by the beneficiary, the presentation of draft or a bill of exchange is enough.

■ Risks in this type of SBLC is the highest in perspective of the applicant, as an error can happen accidentally or on purpose, meaning drawing the SBLC even though non-performance or non-payment did not occur.

● Particular cases of fraud and injunction are a difficult to handle, as the issuing bank can only deny the honouring of the SBLC in case non-complying presentation, however, if evidence is not sufficient enough the issuer is obliged to honour the SBLC.

- As explained in the chapters where risks are collected in perspective of all actors of the Standby Letter of Credit, to bear these high risks it is important to define what is considered as a breach in the underlying contract and the drawing requirements of the specific SBLC.

II.4. Direct-Payment Standby Letter of Credit

- This specific type of SBLC is commonly used in the United States of America.
- As opposed to all other SBLC types, where the drawing upon required documentations guarantees compensation, making it a „last resort” payment for the beneficiary, the Direct-Payment SBLC serves as a primary-payment mechanism instead of a secondary solution.
- The main goal is to enhance credit to a bond offering, so it can be stated that the bond purchase agreement or contract in this type of SBLC is the underlying contract.
- Payment is made by periodic drawings of the SBLC by the beneficiary to finance the interest and principal on the underlying bond. Referring to the name of this SBLC type, the issuer directly pays the beneficiary.

II.5. Commercial Standby Letter of Credit

- Commercial SBLC-s serve as a useful way for the applicant to finance the purchasing of goods and/or services on a continuous basis.

II.6. Insurance Standby Letter of Credit

- The main actors of this SBLC is an insurance company and the individual who has obligations towards the insurance company (in SBLC terms applicant).
- Used by insurance companies to distribute risks.
- This specific SBLC serves as a collateral in the point of view of the insurance company, which is a more efficient form of collateral than the use of cash collaterals.
- The reason is to decrease the risks on liquidity, as cash is one of the most important assets of a company especially for businesses dealing in international trade.

II.7. Customs guarantee

- The customs authority requests this specific type of Standby Letter of Credit, to have a guarantee of payment of the customs duty and/or VAT payable, however the value added tax payable can actually be prolonged and reduced, which is explained below:

- The first condition is the business to be licensed as a so to say „authorised economic operator”. Without being an authorised economic operator the prolonging cannot happen, but the VAT must be paid specifically in cash by the company importing the product and/or service. As explained in the previous chapter this causes liquidity risks for a business.

- The following condition is just as important as the first. The importer must resell the product and/or service to a domestic business. If, the sale for any reason does not succeed the original VAT payable must be paid to the customs authority. In case the sale succeeds between the importer and the domestic company, the difference between the original and resale VAT payable must be only paid.

II.8. Counter-Standby Letter of Credit

In instances, where the beneficiary communicates a need for a local issuer, the applicant might request a counter-SBLC to be issued by a domestic issuing bank or financial institution. This means the applicant can maintain a single line of credit.

■ There will be two SBLC-s issued in this specific scenario

- The counter-SBLC issued, by the applicants point of view their domestic issuer. This will serve as a collateral of the following SBLC issued.

- The SBLC issued in favour of the counterparty of the underlying contract by their domestic issuer

■ The role of the beneficiary differs in the two different type of undertakings.

- The beneficiary will be the „local” issuer in perspective of the counterparty of the underlying contract, who will issue the second SBLC.

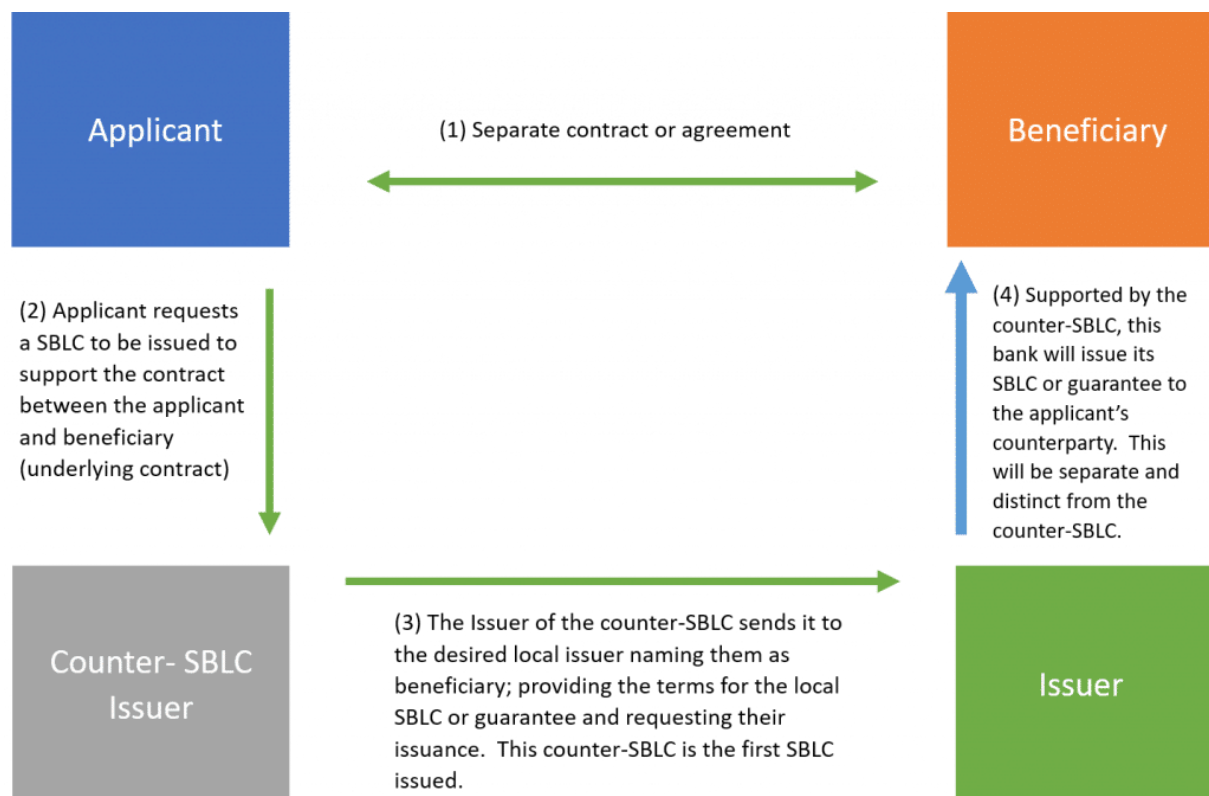
- In SBLC terms the beneficiary, will be the counterparty of the underlying contract.

■ The drawing requirements are also different in the two SBLC-s issued

- A simple statement demanding payment from the counter-SBLC issuer.

- Provided by the applicant of the counter-SBLC issuer.

Additionally, it is significantly important to note that the two SBLC-s are independent and distinct from eachother. Furthermore, the governing rulesets of the SBLC-s do not have to be in alignment with eachother, as policies of issuing SBLC-s might differ depending on the chosen issuer.



III. Rules and Regulations

III.1 ISP98

The ISP98, or can be referred to as ICC publication 590 is the main and most comprehensive ruleset used in governing the SBLC-s. The number 98 refers to the most up to date version of the International Standby Practice, which took more than 5 years to create, as a result of interaction between banks, individuals and international associations. The intention behind the ISP98 was to prepare an internationally used guideline, making obligations, responsibilities of parties and the functioning of the undertaking clear.

Article 1.01

■ Here in Article 1.01 the most important statement is the following:

„ISP is a set of rules that when incorporated into an undertaking by referencing the ISP98 or ICC publication 590, will cause the undertaking to be deemed as a Standby Letter of Credit” (Internet 2)

■ Furthermore, the following information is explained in article 1.01.

- These rules in ISP98 can be applied in domestic and/or international undertakings

These rules can be applied to all different type of SBLC-s (explained in chapter 2)

- By changing wording of the undertaking, deleting and modification of clauses are possible

Article 1.02

- Article 1.02 contains crucial elements to understand, to make these statements clear two hypothetical situations are presented and explained below:

Case 1: A certain SBLC is subjected to law of beneficiary's country

- In this case, the terms of the certain SBLC can supplement the applicable law (law of beneficiary's country), unless the applicable law is conflicting. If or when, the SBLC terms are contradicting the applicable law which the SBLC is subjected to, the law will gain priority over the certain SBLC terms.

Case 2: A certain SBLC is subjected to ISP98 and U-C-P600 or U-R-D-G758

- ISP98 enjoys priority over U-C-P600, in case of conflicting clauses, moreover same rule is applicable when there are conflicting clauses between ISP98 and URDG758.

Article 1.03

- Article 1.03 emphasizes the following facts:

- These rules will be uniformly applied, if any undertaking is subjected to ISP98
- Application of rules of ISP98 makes the undertaking more reliable and efficient.

Article 1.04

- Article 1.04 explains the function of the ISP98 rules

- These rules serve as general terms and conditions of the undertaking, furthermore act as an integral part of the undertaking, unless terms and conditions are expressly modified.
- IS98 rules are applicable to all parties involved in the SBLC deal, however it is important to note the Standby binds the beneficiary only until the extent the beneficiary utilizes the Standby.

Article 1.05

- The fifth point of the first article considers 3 key elements, which the ISP98 ruleset does not provide a guideline for:

- Authorisation: The ISP98 rulesets do not mention, if an entity has authorisation to issue an SBLC undertaking or not.

- Execution: The guideline does not mention the execution of the undertaking and/or how to word the undertaking. The guideline provided in ISP98 only acts as a simplification of interpreting basic clauses.

- Fraud: The rules in ISP98 does not provide a solution in case of fraud.

Rather, the applicable law subjected to a certain SBLC will provide knowledge, whether an entity is authorised to issue an SBLC, how the main clauses have to be framed and worded and what to do in case fraud occurs.

Article 1.06

■ The sixth point of the first article explains the nature of the Standby, as an irrevocable, independent, documentary and binding undertaking. The four mentioned terms are interpreted as the following

- Irrevocable: The undertaking cannot be amended or cancelled without consent of beneficiary. Unless, the previously explained „Evergreen clause” is inserted in the text of the undertaking.

- Independent: As explained before, when drawing requirements are fulfilled the issuer must make payment to the beneficiary, acting as a payment of last resort to them. This payment is independent in nature, whether the applicant pays the reimbursement to the issuer or not and/or, if the beneficiary has a third party to claim the compensation the damages from or not and/or, if the applicant has or has not completed obligations of the underlying contract.

- Documentary: This term means, when the issuer receives the documents required to draw on the SBLC by the beneficiary and these documents are in compliance with the terms and conditions of the SBLC, as well as considered to be genuine on the „face of it” by the issuer, the payment to the beneficiary must be made.

- Binding: Meaning the issuer is binded by the undertaking from the moment the issuance of the SBLC happens.

Article 1.07

■ Point seven of Article 1 explains the relationship between the issuer and the beneficiary.

- As mentioned in Article 1.06, „independency” is the most significant term to understand in aim to gain insight in this relationship. The SBLC is a contract between the issuer and the beneficiary, meaning it is independent of the relationship between the applicant and the issuer, even in cases where the applicant has a liability to fulfill towards the issuer and is still due in the present moment. The issuer must still honor the SBLC, if the beneficiary draws upon the document.

Article 1.08

Article 1.08 deals with the limits of responsibilities of the issuer, these limitations are the following:

- The issuer is not responsible of the breach of the underlying contract, but only responsible to pay upon presentation of complying documents or demand.
- The issuer is not responsible, if the documents presented from the beneficiary are not genuine or inaccurate. If, the documents presented were forged, but on the „face of it” seemed to be accurate and genuine the issuer will not be responsible.
- The issuer is not responsible of actions of any other party involved in the SBLC deal.
- The issuer is not responsible for practice or observance of any other law than the applicable law in accordance with the SBLC. This occurs in international transactions where the issuer is in „country A” and the beneficiary resides in „country B”. If, the SBLC is subjected to the law of „country A”, and the beneficiary follows the laws of their own country, which can mean changes in rules and regulations, the issuer is not responsible for these changes of rules and regulations.

Article 1.09

Article 1.09 defines terms in the SBLC procedure, as well as the explanation of roles of the involved parties in the SBLC deal. The definitions are the following:

- Applicant: Requests the issuance of the standby or issues the standby on its on behalf. When an entity issues the standby on its own behalf the applicant will take the role as the issuer as well.
- Beneficiary: The party who can draw upon the SBLC, by a simple claim or by presenting complying documentation.

- **Business day:** The days a company is open for business.

Confirmer: An entity, which confirms the issuance of the SBLC, and has the ability to step into the role of the issuer. If, the complying documents or demand are presented to the issuer, the issuer must honour the SBLC, on the other hand the beneficiary can choose to present the complying documents or demand to the confirmer, in this case the confirmer must honour the SBLC.

- **Demand:** A request to honour a Standby or a document that makes such request.

Document: Any documents, which are in compliance to draw on the SBLC.

- **Drawing:** A complying demand is called upon the SBLC.
- **Expiry date:** The date on or before the required documents or demand has to be presented to the issuer in aim to be honoured.
- **Person:** Any entity part of the Standby or mentioned in the Standby to perform a particular task.
- **Presentation:** Act of presenting any documents.
- **Presenter:** The beneficiary himself or an entity on behalf of the beneficiary, who submits the required documents or demand.
- **Signature:** Physical intent of signing a document in aim to authenticate it.

Electronic Presentation

Electronic presentation mentioned in section c of Article 1.09 can be characterised by three different characteristics, which means the certain electronic record could being tangible, electronic and authenticated. Below are the explanation of these features:

- **Tangibility:** Presenting demand in form of tangible medium (for example: pendrive), so the issuer can generate electronic record from the used device.
- **Electronic:** The record is sent through an electronic platform (for example: e-mail), so the issuer can regenerate the document in its acceptable form.
- **Authenticated:** Authentication of documents have two crucial conditions, if these conditions are met the document can be termed as authenticated:

- **Identity of the sender must be clearly known**

- Information is intact

Electronic Signature: Associating an electronic record with the use of letters, characters, numbers or any other symbols, when the document is regenerated it is an indicator the document is authenticated.

Receipt: A receipt of an electronic record occurs in two ways,

- The record is sent to the designated place mentioned in the undertaking,

- The issuer can retrieve the document, even though it was sent to an electronic system other than the designated place.

Article 1.10

This article mentions words, so called „undesirable terms”, which should be refrained from using in SBLC documentation. If the following words are mentioned they are considered to be disregarded, furthermore some have a particular meaning associated to them,

- Unconditional or abstract: The term unconditional should not be inserted into a SBLC, this term tends to be misleading, as a SBLC still remains documentary in nature which is explained in Article 1.06. Meaning presentation still has to be made to make a claim.

- Absolute: Meaning it is irrevocable in nature.

- Primary undertaking: Primary refers to the undertaking being „independent”

- Payable from the issuers own funds: This term refers to honouring the SBLC, independent of whether the applicant reimburses the issuer or not, from the funds available in perspective of the issuer the SBLC claim must be honoured.

- Clean or payable on demand: It is suggested not to use the term „clean” or „payable on demand”, as the demand still has to be in accordance with the specific SBLC terms and conditions.

Using the term „and/or”: The term and/or shall not be used in an SBLC undertaking, it can be interpreted in multiple ways. A basic example can help to understand why not to use this terminology

For example: „The claim can be made by simple demand and/or presentation of an invoice”

If, such phrase is used in a certain SBLC, the mentioned claim shall be honoured if any of the three following instances occur, as all would align with general terms and conditions of the hypothetical SBLC.

- Claim made by demand alone
- Claim made by only presenting the mentioned invoice
- Both of the above

■ Meaning of „reinstate or „revolving”: Revolving is in connection with the SBLC timeline, however reinstating refers to the original SBLC value. A basic example can help to understand these phrases. The example is the following.

An SBLC has a validity period of 12 months, financing a supplier-buyer deal, where every second month the buyer must pay via the underlying contract 10 million USD. In this simple case, the SBLC will revolve 6 times, because payment is every second month, but the validity of the SBLC is 12 months.

● On the other hand, referring to the same example given in the last point, „reinstate” means, after every second month, even if the beneficiary drew upon the SBLC, the original SBLC value will be reinstated.

Article 1.11

Opposed to point 10, where non-desirable terms were mentioned, Article 1.11 explains the interpretation of terms, which are used in framing the SBLC. The interpretations are the following,

- Rules of ISP98 shall be used hand to hand with local practices of the SBLC-
- Undertakings subject to ISP98 rules are referred to as „Standby”.
- Issuer: Refers to original issuer as well as confirmer.
- Beneficiary: Refers to original beneficiary as well as the transferee beneficiary.
- „Including" means "including but not limited to"(Internet 2)
- „Words of the neuter gender include any gender.” (Internet 2)
- "A or B" means "A or B or both"; "either A or B" means "A or B, but not both"; and "A and B" means "both A and B"; (Internet 2)

■ Use of the term „unless a standby otherwise states” is a crucial phrase to have an understanding about. It refers to the fact, that the writing, in other words wording of the document of the SBLC supersedes the governing ruleset applied, as the used ruleset rather acts as a „guideline”, as previously explained in the material.

■ When a SBLC contains the term, „Stated in the Standby”, it means in the actual text of the Standby, however the phrase „Provided in the Standby” refers to both the text of the SBLC and the governing ruleset applied.

With gaining insight in the interpretations of roles and phrases, desirable language, nature of the standby and what ISP98 ruleset is intended to provide, the primary goal was to obtain a picture in an everyday persons mind what a SBLC actually contains in its wording, moreover understanding terminology. Article 2 of ISP98 deals with responsibilities of actors within a specified SBLC contract.

Article 2.01

Article 2.01.part a specifies how to interpret the undertakings of the SBLC. Usually it is the issuer, who will honour the draft, however, if a confirmer, as previously explained is mentioned as a party in the SBLC document, they could potentially honour the draft as well. The common feature which cannot be emphasized enough, is payment made by acceptance of credit complying documents and/or demand.

■ The honouring of the SBLC can be performed in different ways. If, the standby does not provide for honour, payment is made at sight, meaning immediate payment by acceptance of complying demand and/or documentation. The following two methods of honouring SBLC has a crucial criteria to satisfy, which is the methodology of the honouring must be worded in the SBLC text to be applicable.

■ The SBLC may be honoured by acceptance of a draft, here payment is made as per the draft. The SBLC might be honoured by undertaking a deferred payment obligation, which means payment on an agreed maturity date.

In aim for the SBLC to be characterised as honoured, the act of the honouring must be performed in a „timely manner”. The phrase has the following meaning:

● Any of the mentioned type of honourings performed by the issuer within the allowed time stated in the SBLC document.

■ On the other hand, in perspective of the confirmer honouring the undertaking, the confirmer honours the SBLC in a timely manner in, in accordance with SBLC terms of honouring the specific document. The confirmer can perform any of the mentioned type of honourings just as the issuer.

There are certain cases where presentation is deemed as wrongfully rejected meaning in simple terms the honouring will not happen, which is in perspective of the beneficiary the most important in an SBLC deal. The beneficiary fortunately has the right, in case of another party mentioned in the certain SBLC to submit demand and/or complying documents to the so-called „non-rejecting party” in aim to get payed.

The actual act of payment by definition without any other mentioned payment terms, is interpreted as payment with the issuers available funds in the designated currency mentioned in the SBLC. However, if the SBLC mentions payment by alternative terms, it refers to paying in equivalent value of, for example:

- Another type of currency
- Equivalent value of gold bar, or other specified items.

Article 2.02

■ This specific point of article two emphasizes the fact that the main responsibility of the undertaking is taken by the actual issuer. Meaning, if a different branch or party is mentioned in the SBLC document, but is not stated as a branch or party who may honour the SBLC, the particular entity will not have the obligation to honour the undertaking, but only has to act in its respective capacities mentioned in the SBLC document. In general, they act as advising banks with no additional responsibilities.

Article 2.03

Article 2.03 explains when an SBLC is labeled as „effective”. The SBLC can be issued via immediate or deferred effect. The meaning of these terms are explained below:

■ Immediate effect: If no special clauses are mentioned in the specific SBLC, once the SBLC leaves the issuers control (so it is deemed issued), the day that happens is the day the SBLC becomes effective. (For example, issued on May.5, so the SBLC becomes effective on May.5)

■ Deferred effect: If, a separate effective date is mentioned in the SBLC document it becomes effective on the specified date, irrespective of the date of issuance.

Moreover, special clauses modifying terms and conditions on effectiveness are to be taken as number one priority over the issuance date.

Article 2.04

As previously explained, there can be different nominated actors stated in the SBLC, whom act within the limits of their respective roles. These roles are highlighted in article 2.04, which includes the following,

- Adding confirmation
- Advising the undertaking
- Acting as a negotiating party
- Acting in any other specific manner mentioned in the SBLC

The nominated party has also the right to reject the request for being an actor in a SBLC deal.

Article 2.05

The most frequently nominated actors of a SBLC are advising banks, requested to be a party of the undertaking by the issuer. This actor which enters the SBLC deal has two main obligations to deal with, which are explained as below:

- **Checking authenticity:** This refers to making sure the undertaking originates from the actual issuer, by means such as authentication by use of swift communication system.

- **Making sure information is untouched and unharmed:** This is self-explanatory, and must be done by the advising bank before forwarding the document to the beneficiary.

Furthermore, if the nominated actor decides not to accept the request by the issuer, their responsibility is to noticate them about this, in aim to route the undertaking to a different institution (usually a bank), who can act within the respective role of an advising bank.

Article 2.06

Amendments in SBLC-s are a very important feature to take into consideration, as if not understood and known, the potential for serious misunderstandments are at higher risk. These amendments can be differentiated, as amendments with automatic clause and amendments without automatic clause. The two types are characterised by the following information:

■ Amendment with automatic clause: The main and most important characteristic of the automatic clause, is that it is inserted in the original SBLC contract, meaning the specific SBLC was accepted with the inserted automatic clause. Therefore, the consent of the beneficiary is not needed for these predefined changes to be made.

■ Amendment without automatic clause: The applicant may request the issuer to amend their request, as there is no automatic clause inserted in the original SBLC contract, the requested changes cannot be made without the „explicit acceptance” of the beneficiary. This means, the entire amendment must be either accepted or rejected by the beneficiary, it cannot be partially accepted or rejected.

Furthermore, in case of amendments without automatic clauses, the issuer and/or confirmer will be the only party bound by the changes in the undertaking, even if a mistake occurs due to miscommunication or mistyping...etc. To understand more, a simple example below is provided:

● The applicant requests the issuer to change the SBLC amount from 200,000\$ to 80,000\$, but the issuer interprets it as a reduction of 80,000\$ in the SBLC amount instead. In this case, the SBLC amount will be mistakenly issued at 120,000\$, which can be drawn upon by the beneficiary. Unfortunately, the issuer does not have the right to ask for a reimbursement of 120,000\$ from the applicant, as the requested SBLC amount was 80,000\$. By law, the applicant is not obliged to pay, only the requested amount.

Article 2.07

Article 2.07 serves as a guideline in managing amendments in SBLC deals. As previously explained in different points of article 2, the issuer is the party in the SBLC deal who will assume liability over the undertaking, even in cases of misunderstanding. The following example supports understanding responsibilities of parties in amendments:

■ If, for example an issuer receives an amendment to cancel a SBLC deal, however the nominated party (in this case confirmer) does not in time receive amendment instructions by the issuer (usually due to time differences) and make payment towards the beneficiary. In this case, the issuer will be liable to cover the amount paid towards the beneficiary from the confirmer.

Moreover, point seven emphasizes the importance of the role of the advising bank. The advising bank respective of its role, must advise on all requested amendments and of course on the

original wording of the SBLC. It is advisable, to nominate only one advising bank for amendments requested in a certain SBLC deal to maintain consistency in the activity.

■ It can be stated, article 2 summarizes responsibilities of actors of a specific SBLC contract, when a SBLC enters into effect, as well as explains the use of amendments inserted or not inserted into a SBLC contract. The next article, article 3 provides information about the act of presentation in a SBLC deal, moreover general rules and conditions applied in connection with presentation.

Article 3.01

Article 3.01 states conditions, whether presentation made by the beneficiary are referred to as acceptable or rejected. Three main conditions of presentation must be met to be accepted, which are the following:

■ Time: Presentation must be made on or before the expiry date stated in the SBLC contract. In accordance with time, it is also crucial, that presentation can only occur within „business hours” (term explained in article 1.09)

■ Place: The address mentioned in the specific SBLC contract where presentation has to be made.

■ Presentation can be made either on paper or electronically. Article 1 contains a section about conditions of electronic presentation.

Article 3.02

■ Article 3.02 simply clarifies what is considered to be a presentation. The general rule is, any document that is presented with the conditions met in the first point of this article and complies with SBLC general rules and conditions, is considered to be a presentation, even if the presentation is only partial. Partial means not all mentioned documents in the specific SBLC terms are presented, but at least one, however it is still considered to be a presentation in terms of SBLC Article 3.02.

Article 3.03

■ Article 3.03 emphasizes how to deal with identifying the correct SBLC. In certain scenarios, where the same (in simple terms) supplier and buyer have multiple SBLC deals with each other, when presentation is made, it is crucial to identify the specific SBLC presentation is made upon.

■ The most important indicator is the so-called „reference number”, which is a number used in aim to verify the correct standby. If, the reference number is unknown, the issuer might identify the SBLC by seeking contracts in relation with the certain SBLC, or by indentifying the nature of goods and/or services being sold.

■ Furthermore it is significant to clarify, the period of time in the SBLC contract for examination starts only, when the issuer is able to identify the specific SBLC reference number.

● For instance, if presentation should be made on May.5, but the identification of the correct SBLC happens on May.10, then the presentation time period will start on May.10.

Article 3.04

To successfully present, it is important to know specifically where and to whom the presentation must be made, this information is emphasized in article 3.04. The location and recipient of presentation depends on the wording of the certain undertaking, however the following cases provide answers and solutions in regards of whom and where to present to:

■ In case of direct issuance: Documents and/or demand are presented in the mentioned place of the SBLC, if address is unknown, then presentation is made at the issuer’s place of business.

■ In case of confrimed undertaking: Presentation can be made either to the confirmer or the issuer

■ In cases where address is considered „incomplete”: Meaning, specific location of the place of presentation is not specified (for instance: which department of a company), presentation can be made at any location within the mentioned place, which is designated to receive deliveries, and/or to an authorised person to recieve a SBLC.

Article 3.05

■ Point five of article 3 explains what is considered to be a timely presentation. In simple terms, presenting on or before the expiry date stated in the specific SBLC contract means the presentation is deemed as timely. However, it is important to note, in cases where presentation is made after business hours, the presentation will be considered to be received on the next working day. This is a significant piece of information to keep in mind in perspective of the beneficiary.

Article 3.06

Article 3.06 differentiates presentation between presentation by physical form and presentation via electronic form. The main consideration to keep in mind, is that the medium used for presentation must be in alignment with specific SBLC terms and conditions. The general rule is, if terms and conditions of the specific SBLC does not include information about medium of presentation, presentation can only be accepted in paper form.

- However, an exception of the above rule occurs, if presentation can be made by only a simple demand via SBLC terms, meaning no complying documentation is needed. In this case, submitting demand in electronic format is accepted too. This is usually done by use of the swift system, but must be authenticated. Authentication is explained more in depth in article 1.09.

Article 3.07

- The act of representation, moreover the right to present complying documents, even if rejected before are emphasized in Article 3.07. This means, even though the beneficiary's presentation was rejected before, if they perform the presentation afterwards and the presentation is deemed complying by the issuer as well as done in a timely manner, the issuer is obligated to pay the beneficiary due to rightful presentation of complying documents.

- On the other hand, there are situations where the issuer might not recognize a discrepancy in the presentation, and honours the SBLC, even though requirements are officially not met via SBLC terms. If, the issuer receives another drawing upon the specific SBLC, but this time realizes the discrepancy in the presentation, the issuer must dishonour the SBLC. In perspective of the beneficiary, this means the beneficiary cannot refer to the previous presentation being accepted, as it has become clear in perspective of the issuer, that the submitted documents were not in compliance with SBLC terms and conditions.

- The above instances refer to the characteristic of separateness between the demands presented to the issuer by the beneficiary.

Article 3.08

Article 3.08 deals with so-called „partial drawings” of the SBLC and the just previously explained right for multiple presentations. A partial drawing is referred to the fact, that „A presentation may be made for less than the full amount available”. (Internet 2)

- If a certain SBLC contains the phrase: „Partial drawings prohibited”: It emphasizes the fact that the certain SBLC can only be drawn upon the entire SBLC amount specified in the contract.

■ If a certain SBLC contains the sentence: „Multiple drawings prohibited”: The phrase insists, that honouring the SBLC by making payment can be only done once by the issuer, even if it is only a partial payment.

By default, both features, specifically partial drawings and multiple drawings , if not stated as prohibited are accepted features of a standard SBLC contract.

Furthermore, this article provides an interpretation of discrepancy of the demanded amount by the beneficiary. The demand is deemed not discrepant, if the documentation required for presentation suggests an amount, which is equal to or exceeds the demanded amount. However, if documentation supporting the demand suggests an amount less than the demanded amount or the demand exceeds the full SBLC value, the demand is deemed as discrepant.

Article 3.08 also suggests, „Use of"approximately","about","circa", or a similar word permits a tolerance not to exceed 10% more or 10% less of the amount to which such word refers”.
(Internet 2)

Article 3.09

The ninth point of article 3 explains the options available in perspective of the beneficiary, when the applicant does not perform obligations of the underlying contract. The beneficiary can insist on extending the expiry date of the SBLC or demand immediate payment from the issuer.

■ When this mentioned situation occurs, the issuer forwards the request to the applicant, who will decide whether the expiry date of the SBLC is ought to be extended, or the applicant may just want to pay the stated SBLC amount. Both situations are only honoured when presentation of complying demand is deemed successful.

■ It is also important to highlight, a significant feature of the „pay or extend” possibility, which is that only one of the options can be exercised by the beneficiary, meaning either the extension of the expiration date happens or the full SBLC amount will be paid to them.

Article 3.10

Point ten of article 3 mentions the fact that the issuer is not requested to notify the applicant in case of receiving a demand from the beneficiary. In the previous point, where the „pay or extend” option is utilized, the issuer must inform the applicant in case of extension of the expiry date, as this means commitment with the issuer for an extended time period.

Article 3.11

Article 3.11. provides certain „waives” by the issuer, in order to maintain operational convenience in SBLC transactions. Specific articles of ISP98, which can be waived are the following:

- Article 3.02: The principle that the presentation must be made on or before the expiry date of a certain SBLC can be waived, usually requested by the beneficiary. In certain cases, when the beneficiary can only make presentation, for example before the presentation time period, the issuer might accept the request of the beneficiary to present one or two days earlier. The issuer keeps the earlier presented documents until the presentation time period starts, then handles the documents as they were presented on the first day of the presentation time period. If documents are complying with SBLC terms, the beneficiary must be paid, even though presentation was made „earlier”.

- Article 3.03: In regards with the presentation made, article 3.03 explains the importance of the reference number in identifying the correct SBLC, however this rule can be waived, if the issuer can identify the correct undertaking by another methodology.

- Article 3.04: Article 3.04 emphasizes the location of the presentation, which must be made in the place the undertaking was issued. However, the issuer usually allows the beneficiary to present at any other office of the issuer in the same country the SBLC was issued.

- Article 3.05: The issuer has the ability to accept presentation after business hours, if decides so.

Furthermore, if the request is accepted by the issuer, the following presentations can be deemed accepted.

- Documents presented stating a future date.

- Documents presented in a different language than the language of the original SBLC.

- Documents presented electronically, in cases where presentation can be made by a simple demand, and the beneficiary must be a participant in the SWIFT system.

Article 3.12.

- Here in article 3.12, it is assumed, that the beneficiary lost the original SBLC, which is required document for a successful presentation. The issuer has the ability to support the beneficiary by issuance of a duplicate SBLC, but are not obligated to do so. If, the issuer decides

to issue a duplicate SBLC indemnity is required from the beneficiary, furthermore the reimbursement obligations of the applicant still remains effective, in case where the beneficiary makes successful presentation.

Article 3.13.

The following points of Article 3.13. are applied, if the last day of a successful presentation by the beneficiary mistakenly is a non-business day.

- If the last day of presentation mentioned on the original SBLC is not a business day, in practice it means this date is shifted to the next business day, which is considered the actual last day the issuer can accept a complying presentation made by the beneficiary.

- If, a nominated entity by the issuer has the ability to honour the SBLC and accept presentation by the beneficiary, but on the last day of presentation the nominated entity is closed, the beneficiary can present on the next day the nominated entity is open for business. The nominated actor has the obligation to notify the original issuer that presentation was made in a timely manner.

Article 3.14.

Article 3.14. explains the rights of the beneficiary, when presentation was not successfully made in a timely manner, due to the fact that the issuer or other place of presentation was closed on a business day. The following points are mentioned:

- Unless stated otherwise in the specific SBLC, if the issuer or any other place of presentation, where presentation can be accepted and deemed successful is closed on a business day, the beneficiary has the right of presentation from the day the place of presentation re-opens and 30 additional calendar days.

- In instances, where the issuer knows the place of presentation is not open for business on the last day or week before a successful presentation can be made, an alternative location for presentation can be suggested. The main condition is that the suggestion must be made 30 days prior of the last day of presentation, on the other hand the beneficiary gains 30 extra days for successful presentation, if issuer fails to notificate the beneficiary within 30 days.

Summary of ISP98

As mentioned before, ISP98 serves as a guideline with the goal to obtain a basic knowledge about the standards of an SBLC documentation features, nature, as well as interpretation of

phrases. ISP98 consists of 7 more articles, which provide information about transferability and the main conditions of the feature, cancellation as a feature, reimbursement...etc. The goal of the material is to give an everyday reader, who is assumed to not have any knowledge about this particular financial instrument, a more in depth understanding about the topic. It is assumed that an everyday person with acquiring the information via only this particular material gains the ability to enter a SBLC deal in a confident manner. As explained in the beginning of chapter 3, ISP98 is the primary governing ruleset of the SBLC, however in fewer cases there could be different rulesets applied which are still crucial to mention. These particular rulesets are the following:

III.2.Uniforms Customs and Practice (U-C-P-600)

- By definition „U-C-P is a set of rules that that when incorporated into an undertaking, will cause the undertaking to be deemed as a letter of credit.” (Internet 1)
- However, U-C-P also governs the SBLC, “to the extent to which they are applicable”.
- When U-C-P is applied in an SBLC, as the governing ruleset, there is a significant lack of information regarding plenty of crucial elements of a SBLC. ISP98 serves as a much more specific guideline for the SBLC.¹
- U-C-P is one of the oldest governing rulesets, the first publication was made in 1933.

III.3.Uniform Rules for Demand Guarantees (U-R-D-G-758)

- By definition, „The U-R-D-G is a set of rules that that when incorporated into an undertaking, will cause the undertaking to be deemed a demand guarantee.” (Internet 1)
- Demand guarantee’s should not be misunderstood as suretyship guarantee’s, as there is no such element as secondary liability in the case of DG-s.
- U-R-D-G758, the latest version of the governing ruleset is in effect since 2010.

The final chapter of the thesis consists of problematic situations occurred when the SBLC was applied for. The intent behind this chapter is to give light to factors, which can cause potential cases of for example fraud or in simple terms mistreatment.

IV.Fraud and injunction

IV.1.Independency

In ISP98, the term independency is defined, which characterises the nature of a SBLC. In a certain perspective independency makes a SBLC quite attractive, furthermore this feature enhances commercial results. In some cases, a breach of the underlying contract occurs by either the applicant or beneficiary in SBLC terms. However, there are significant differences between the actual situation of the two mentioned parties, which are the following:

■ The beneficiary has more financial security, meaning either getting payed or performance being done via conditions and terms of the underlying contract, or getting payed by the issuer in SBLC terms due to presentation being honoured as explained before.

■ On the other hand, the applicant assumes a risk of loss in a handful of cases. Horrific situations can even occur, where the breach of the underlying contract is done by the beneficiary in SBLC terms, who has successfully presented required demand to the issuer to get payed. The term „horrific”, refers to the fact, that as the benefits are not recieved by the completion of obligations in the underlying contract by the benficiary, the applicant in SBLC terms may not have the means to pay the reimbursement to the issuer, resulting to insolvency.

The following chapters consists of specific cases, where there was an obvious fraud by the beneficiary in the underlying contract.

IV.2.The Sztejn case

This particular case was the motivation to introduce codes and regulations in regards of customer protection. More specifically, referring to situations in L/C or SBLC deals, where the honouring of the specific document means defrauding the customer. The aim of such regulations is to prevent honouring fraudulent demand made by the beneficiary.

The beneficiary here was an indian company selling bristles. An irrevocable commercial letter of credit was issued by the defendant bank, in favour of the indian entity, if payment does not occur via the underlying contract. The supplier placed the goods on ship, obtained a bill of lading by the transportation company and gathered all required documentation for presenting a draft to the defendant bank. The buyer (Sztejn), however made a complaint towards the issuer of the commercial L/C, that instead of the bristles, boxes of the shipment were filled with cowhair and other worthless material.

Eventually, the complaint was dismissed and payment was made, due to the principle of independency. The defendant bank interpreted the presentation of the beneficiary as successful,

therefor payment was needed to be made, even in this case of a clear breach of the underlying contract. Fortunately, this case as previously stated, acted as a motivator in making exceptions of the principle of independency in instances of beneficiary fraud.

IV.3. Case LAKON ATE vs Municipality of Paphos.

In this certain case, LAKON ATE requested its bank to issue a guarantee in favour of the Municipality of Paphos, as LAKON ATE became the successful contractor of an infrastructure project by the municipality. Disputes between the two sides led to a termination of the underlying performance guarantee contract. LAKON ATE in response initiated an injunction to prohibit presentation of demand by the municipality. Below, an explanation of the results of the case is provided:

- The result was mainly dependent of whether the undertaking is conditional or unconditional. Unconditional undertakings are all related to, the just previously explained principle of independency and the principles setbacks.

- As the undertaking by the issuing bank was unconditional in nature, the bank had the obligation to honour the guarantee.

- The court annulled the injunction, as demand was already honoured before the injunction was requested by LAKE ATON, furthermore stated there was no clear sign of fraud.

To conclude the takeaways of chapter 4, specifying the above detailed cases of fraud and injunction to the SBLC is crucial, as the topic of this material is the Standby Letter of Credit.

- In general, there is limited communication between the applicant and issuer in SBLC terms or in L/C terms, as the undertaking is between the issuer and the beneficiary.

- However, in the case of applying an L/C as a form of security, it is a primary form of financing the underlying contract, when the required documentation is successfully presented it is an indicator to the issuer, that everything went well in terms of the underlying contract too.

- In case of a SBLC applied for, the issuer assumes a breach of the underlying contract must have happened, if the beneficiary insists on drawing the SBLC. In most instances, the SBLC is expected not to be drawn upon.

Moreover, UCP section 5-114 point 2/b mentions the ability to dishonour the presentation made by the beneficiary. When a SBLC is used as security of an underlying contract, the applicant is notified that drawing occurred, so the issuer can obtain reimbursement. However, in cases

where fraud or other suspicious activities are communicated by the applicant to the issuer, the issuer might try to seek for any mistake of the presentation of demand, so the demand can be dishonoured.

Unfortunately in the perspective of the applicant, the SBLC still remains in nature an independent undertaking, so even if the SBLC would have been applied in the „Sztejn case” or the case of „LAKON ATE vs Municipality of Pharos”, the judicial results would have remained the same.

As a conclusion, furthermore mentioned in the chapter „Risks in perspective of the applicant”, it is crucial especially in the point of view of the applicant in SBLC terms, to have significant evidence of clear fraud by the beneficiary before going to the court. Historically, independent undertakings are hard to deal with in court cases, due to the nature of the undertaking.

Summary

As stated in multiple instances throughout the material, the goal was for a person without any knowledge of the Standby Letter of Credit to gain the ability to enter as a beneficiary or an applicant in a confident manner. This material contains sufficient information enough about the SBLC to obtain this ability. However, in regards with chapter 3, rules and regulations are definitely better to be examined more carefully and recommended to do so with the support of a professional who can interpret the applicable law correctly.

Most importantly, the material gives several answers to the presented research questions in the introduction part. The following conclusion can be made in accordance with the research questions formatted in the introduction part:

The Standby Letter of Credit is an attractive financial instrument used in international trade, the appliance of the SBLC can facilitate growth as deals can be secured, which without the use of the instrument would not be possible. The most important features of the document to obtain broad knowledge about is the requirements for drawing on the specific SBLC, as well as the nature of the Standby, as it is an independent undertaking. The SBLC is considered as a trustworthy instrument, which is proven by the data provided for the popularity of the instrument, more specifically the instrument being one of the most used documentary trade products especially in the United States of America. On the other hand, negative outcomes occurred in certain cases presented in chapter IV of the material, where usually the root of the

problem is unrightful drawing of the SBLC. Consequently, significant changes occurred in rules and regulations governing the instrument, making the possibility of fraud much lower.

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Signed declaration

DECLARATION

DECLARATION

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Name: Farkas Károly Dávid

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