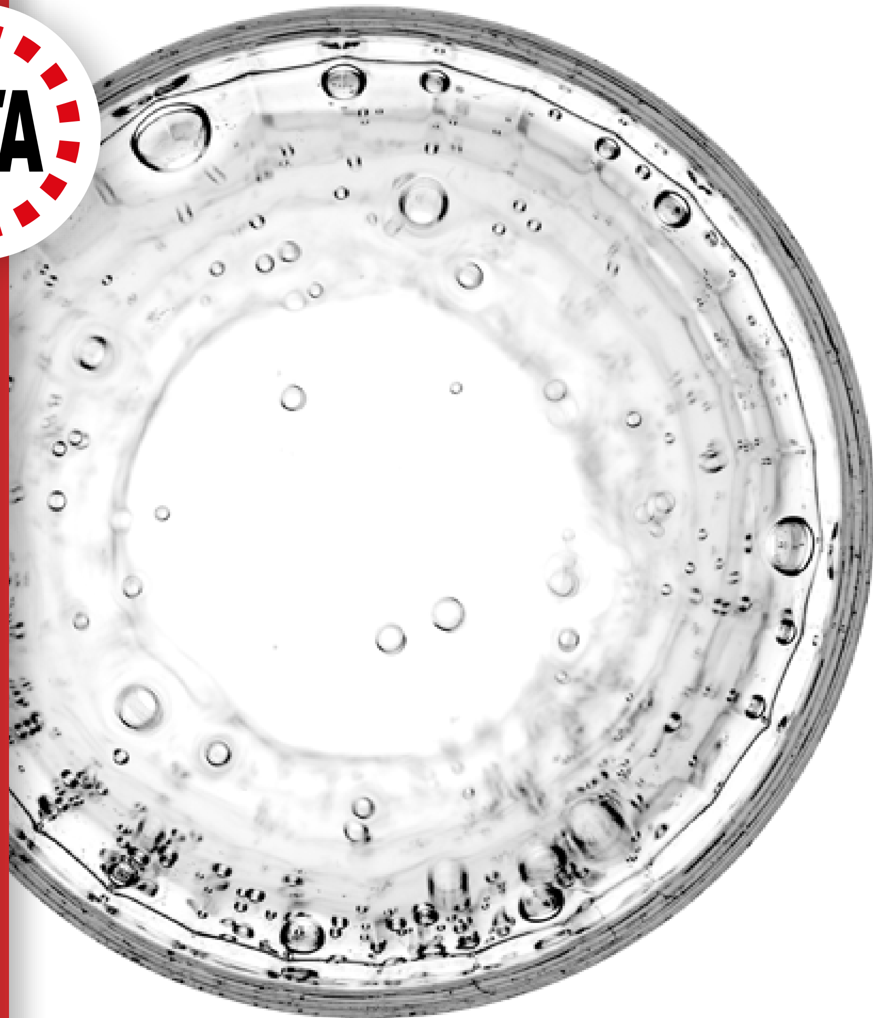

THE ITFA GUIDE TO

Structured Letters of Credit

itfa.org

April 2021

Executive Summary

Based on input from market participants (banks, commodity traders and lawyers) this guide seeks to enhance understanding of Structured Letters of Credit and the issues surrounding their use in the market.

It looks at the history and development of Structured Letters of Credit and then investigates:

- Characteristics and typical “flags” to help identify Structured Letters of Credit;
- Comparison of Traditional Letters of Credit v Structured Letters of Credit;
- Commercial purposes of Structured Letters of Credit and their role in the market;
- Issues specific to each of the Trader, the Issuing Bank and the Confirming/Discounting Bank(s);
- Legal issues; and
- AML and Risk issues.

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1. Foreword & purpose of the guide

Working together with banks, commodity traders and lawyers active in this area, ITFA has produced this guide to Structured Letters of Credit ("Structured LCs") with a view to providing greater transparency and understanding of a product which has been in use, in one form or another, for nearly 30 years and has provided substantial funding for emerging market banks which would not otherwise have been available.

These instruments have sometimes attracted controversy in part because of a lack of understanding of what they are and what they are seeking to achieve.

This Guide attempts to provide clarity in this area whilst also pointing out the risks.

So far as ITFA is aware, no other publication exploring the operation of Structured LCs to the depth, and in the detail of this paper, has ever been made available. Consequently, some have regarded Structured LCs as operating in a murky and uncontrolled environment. As this paper shows, such charges are unjustified when the products are properly structured and explained. In this regard, they are no different to many other financial products whose use relies on the proper education of all participants based on adequate disclosure.

This paper ensures that a proper light is shone on these products and we are confident that a wider audience will now be able to understand and use them safely and effectively.

It is worth noting that there are many variants of Structured LCs. This paper focuses on the most prevalent, with a view to explaining the basic concepts and drawing comparisons with other forms of financing. Readers will note that the Guide has been headed "Structured" Letters of Credit and we have used this term throughout the document rather than "synthetic" or "prepaid" letters of credit or other similar terms sometimes used to describe this type of letter of credit arrangement. In referring to such letters of credit as "structured" we are using this term in its widest sense. It is not our intention to imply that any transaction incorporating a structured letter of credit is automatically comparable to what is more widely accepted as traditional "Structured Trade Finance" (such as borrowing base facilities, pre-export and prepayment finance, warehouse financing, export credit agency finance, trade receivables securitisations etc.). Any such categorisation or classification, and the usefulness of doing so, is a matter for users.

Finally, ITFA wishes to thank all the members of the working group for their hard work and contributions in producing this Guide.

2. Glossary of Terms

KEY TERMS

Structured Letter of Credit or “**Structured LC**”: Structured Letters of Credit, sometimes known as, “synthetic” or “prepaid” letters of credit come in differing forms but like traditional LCs their terms usually guarantee the seller will receive payment once their obligations are fulfilled. However, they typically involve the bank issuing the LC receiving some or all of the funds to cover the LC upfront. As can be seen from section 3.2 below, other characteristics to help distinguish a Structured LC from a Traditional LC are likely to include some or all of the following:

- (i) high amounts
- (ii) deferred payment 180/364 days
- (iii) location of LC participants differs from route of transport (e.g. Issuing Bank not in buyer’s jurisdiction and Confirming Bank not in seller’s jurisdiction)
- (iv) copy transport documents acceptable
- (v) “stale documents” and late shipment acceptable
- (vi) Issuing Bank in emerging market jurisdiction

Traditional Letter of Credit or “**Traditional LC**” (also known as a documentary credit): A common form of payment in international trade, under which a bank agrees to pay the seller, in connection with the export of specific goods, against the presentation of specified documents relating to the shipment of those goods. The Traditional LC is issued at the request of the buyer (the applicant for the credit) in favour of the seller (the beneficiary of the credit).

The key parties to a Structured LC

1. The “**Trader**”: often the “originator” and the “distributer” of Structured LCs is typically a non-bank, commodity trader, (now sometimes a global corporate) with significant merchant trade activities with billions of dollars of un-monetised cargoes on the ocean, at any given time.

2. The “**Issuing Bank**”: usually an emerging market financial institution which needs improved access to USD liquidity and pricing, has a trade platform capable of issuing LCs and correspondent trade relationships with international banks willing to take their risk through LC confirmations.

3. The “**Confirming Bank**” and/or “**Discounting Bank**”: usually, a developed market correspondent bank with trade risk appetite on the Issuing Bank and access to well-priced short term trade dollar liquidity.

3.History and purpose of Structured Letters of Credit

3.1 Introduction

Over the last 25 years or so Structured LCs have emerged as a variant of Traditional LCs.

Financially sophisticated commodity traders often use Structured LCs to enhance returns over and above their core physical trading businesses. This usually takes place while a physical transaction is in transit on the high seas and before the underlying goods reach the destination port, where title documents pass to the end buyer.

After entering into a sales contract with an end buyer, the Trader will sell those same goods in a financial transaction, usually with a related party which is the financial buyer. The financial buyer applies for a deferred payment LC with a bank seeking financing. In order to obtain cash upfront the Trader discounts the LC with its line bank and forwards the funds to the Applicant who uses the proceeds to prepay its deferred payment LC obligation at a discount. The difference between money earned on funding the bank and the discounted proceeds is the financial gain. The net result is that the Discounting Bank indirectly finances the LC Issuing Bank and the commodity trader receives a fee for facilitating the transaction.

Structured LCs are commonly issued after the physical bills of lading are cut and the terms generally match the underlying transaction. However, the documents required are usually copies and Structured LCs often explicitly allow for all discrepancies between its specifications and those of the bills of lading and other documents to be waived.

History and Development of Structured LCs – Phase One

In the mid-80's a large commodity trader was approached by its bank with a novel way to use the GSM-102 program offered by the Commodity Credit Corporation of the US Department of Agriculture (the "**CCC**") which supported the export of US bulk agricultural products. CCC did this by offering banks a 98% guarantee of repayment on LCs issued by foreign banks for the purchase by their customers of those products. Typically, a foreign buyer would open a CCC- related LC through its bank, which would direct it to a bank in the US that participated in the program. That bank, having first obtained the guarantee, would then advance funds under the LC to the foreign bank for a term of three years (as then allowed under the program) which would then typically lend the money to the buyer for 6 months. At maturity, the bank would keep the money for the remainder of the three years as general working capital.

The bank told the commodity trader that, instead of selling directly to the foreign buyer, it should set up a subsidiary in countries where it had large bulk sales and sell to it, thereby allowing the subsidiary to be the applicant on the CCC LC. The credit on the LC application was covered by a commodity trade standby letter of credit. Since the subsidiary would not need a loan from the foreign bank it could immediately prepay its obligation from the proceeds of the sight sale to the end buyer at a discount. Since the discount covered the full three-year term, it was quite lucrative. For example, at the height of the Asian financial crisis in 1999, the discount on LCs issued by Indonesian banks was 1000bps. This was because the CCC program was the only source of funding available to most Asian banks at that time. The commodity trader could use the discount (basically a fee charged to the Issuing Bank for access to cheap funding under the CCC program) as a way to buy down the cost basis on the underlying commodities. In most cases, this allowed the commodity trader to offer more competitive pricing and thus gain market share. They used to refer to it as a "margin stretcher".

This structure also established the two basic steps in almost all structured transactions: to sell on a term basis to an entity (usually a related party) to set up the debt obligation and then prepay that obligation at a discount with the proceeds of the sight sale.

In the 1990s, commodity traders started to adapt this CCC structure to commodity exports in a variety of geographical areas.

The first structure developed was called a Bank Transit Trade to provide 180 to 360-day financing to banks using the types of LCs noted above. While the goods from the physical sale were in transit (hence the name Transit Trade) a trader would arrange for a related party transaction using copy title documents and then discount the LC with one of its line or other bankers as a commodity

trader related trade transaction. This structure was, in effect, a shorter-term version of the CCC product. Maturities on this product have gradually been lengthened so that they bear little resemblance to the lifecycle of the underlying commodity.

Thus, all the elements of structured transactions were created: the commodity trader would sell product under term LCs to a related party which would either sell it back or on-sell to another related party at sight. The proceeds of the sight sale were used to prepay the LC obligation. As mentioned above, these trades were done on the back end of an existing trade between the commodity trader and an end buyer while the goods were in transit and before title documents passed. The commodity trader's lawyers felt that they had enough of an interest in the goods up to the point of title transfer to the end buyer to justify the structured or financial transaction but, to be safe, the Structured LC called for copies of the title documents or bills of lading.

The next structure created was called a Corporate Transit Trade and placed a company in the middle of an existing trading pattern to obtain working capital financing. A commodity trader would sell to a company on 180-day terms which would either sell it back to the commodity trader or on-sell to a related party at sight. These were done while the goods from the original transaction were in transit on the high seas. These were then sold to banks as trade transactions related to the commodity trader under silent funded participations.

The above were (are) the basic structured transactions but have been expanded to include FX legs, future flow transactions and third-party arbitrage transactions.

History and Development of Structured LCs – Phase Two

In the late nineties, it became apparent to other commodity traders that at least one of their competitors had some "***secret sauce***" that allowed it to under-bid the market for its commodity sales and win additional market share. As discussed above, the commodity trader was using its "***margin stretcher***" strategy to subsidise the cost basis of the underlying commodity sales.

The concept of such structures spread to other commodity traders. The same basic products of CCC arbitrage, bank transits and corporate transits were used to support the flows of these additional players in trade finance. However, not every firm wanted to hire and/or build an in-house team to execute these transactions. Instead they would either contract out the service to traders for a share of the profits or, in some cases, simply pay fees on individual transactions.

History and Development of Structured LCs – Phase Three

With the spreading of trade finance expertise came additional players who discovered that what they really needed were three basic elements namely (i) Origination, (ii) Structuring and (iii) Distribution. Origination identified the entities that required financing; Structuring took care of the details of the transactions; and Distribution laid off the risk into the market and ensured a profit. With these three elements in place they then needed flows of bulk commodities to complete such transactions.

The basic structures outlined above were used as they were familiar to both origination (borrowers) and distribution (discounting banks). Traders would first contract with a commodity provider to buy and immediately sell back a cargo that was in transit on the high seas. No principal needed to change hands with the contract amounts netting out and the difference between them amounting to a fee paid to the supplier for the use of the flow. While this was being negotiated, the Trader could arrange for an LC opening line of credit with a bank needing financing by way of posting cash collateral in the form of an interest bearing deposit which would be equal to and cancel the term LC obligation at maturity. Knowing their costs and profit potential they could then arrange to pre-sell the transaction to a discounting bank to lock in a profit. Such transactions do not however, represent the bulk of the current market.

3.2 Description and benefits

Structured LC business combines the financing of a real flow of commodities using the instrument of deferred payment LCs with the purpose of providing funding to financial institutions (importers' bank / LC Issuing Bank) in mainly emerging markets and realising a benefit from other arbitrage (FX / interest rates) for traders.

Characteristics

Structured LC business uses a flow of commodities to create additional value for the parties involved. Examples include:

- interest arbitrage through favourable refinancing of the LC Issuing Bank, mainly in emerging markets, when discounting proceeds are indirectly transferred back to the Issuing Bank;
- the Trader may receive higher fees / interest from the LC Issuing Bank for depositing the discounting proceeds compared to discounting costs (or other beneficial treatment);
- the Issuing Bank may receive more attractive funding from deposit compared to loan market; and
- the margin for bank risk discounting may be lower than the risk margin for the Trader to borrow money.

Typical flags to identify a Structured LC (some of which may also be present in a Traditional LC)

- High amounts (e.g. USD/EUR 5,000,000 – 50,000,000) or near to significant thresholds (e.g. USD/EUR 24,999,999.97)
- Deferred payment 180/364 days (with / without financing request)
- Location of LC participants differs from route of transport (e.g. applicant located in Nassau / Bahamas – beneficiary out of Singapore – shipment from Argentina to UAE)
- Transport documents (e.g. BL) acceptable in copy or Letter of Indemnity (LoI)
- "Stale documents" are acceptable
- Late shipment acceptable
- Discrepant documents are accepted already upfront (LC clauses like: "all discrepancies are acceptable" or "documents accepted as presented")

Comparison of Traditional LCs v Structured LCs

	Traditional LCs	Structured LCs
Main Purpose	Secure a trade-related payment of an underlying delivery (counterparty risk mitigation)	Provide funds for the LC Issuing Bank through the use of an underlying delivery / other arbitrage types
Trade Flow	Sale of commodity to external Traders (i.e. applicant of Traditional LC is not related to the beneficiary of the Traditional LC)	Mostly intra-group sale of commodity to related party (i.e. applicant of Structured LC is related to beneficiary of Structured LC)
Payment of deferred payment obligation	1. Applicant vis-à-vis Issuing Bank: applicant pays deferred payment obligation when due (e.g. after 364 days) 2. Issuing Bank vis-à-vis Confirming Bank: Issuing Bank pays deferred payment obligation when due (e.g. after 364 days)	1. Applicant vis-à-vis Issuing Bank: applicant agrees with Issuing Bank to prepay its deferred payment obligation immediately at a discount* 2. Issuing Bank vis-à-vis Confirming Bank: Issuing Bank pays deferred payment obligation when due (e.g. after 364 days)

	Traditional LCs	Structured LCs
		* Note: Instead of a prepayment, the applicant may choose to provide the Issuing Bank with cash cover at an agreed interest rate, which will be higher than the cost for the confirmation / discounting of the Structured LC.
Copy Documents	May be allowed	Allowed
Late documents presentation	May be allowed	Allowed
Late shipment	Usually not allowed	Allowed
Discrepant LC documents	May be allowed	Allowed
Beneficiary	Mostly Non-Group Company	Mostly Group-Company
		Note: The underlying factual trade transaction is still transparent based on the documents presented (some documents issued by independent 3rd parties).

Note: In a Traditional LC, characteristics of a Structured LC may appear as well and vice versa.

3.3 Commercial purposes and role in the market

Each of the three counterparties participating in Structured LCs has their own clear commercial motives associated with their roles in the transaction which enhance their economic position through their use of such instruments.

The product has evolved since its genesis in the 1990s, and there have been many innovative permutations over the last three decades, which vary the operational mechanism, relative geographies, nature of the underlying security and the use of the lending it generates.

There is a significant divergence of views in the market as to the commercial purpose and benefit derived by each of the parties to a Structured LC. This also varies considerably depending upon the terms and circumstance of any Structured LC structure but we set out below some examples of the purpose and benefits as they might apply to the parties of a Structured LC. This list is not exhaustive:

3.3.1 The Trader

Traders will wish to benefit from the significant volume of cargoes they have on the water at any time as a result of their normal global trading activities by use of their global banking relationships.

With a Structured LC a Trader may benefit from the 'arbitrage' differential in price between the deposit rate they charge the emerging market Issuing Bank and the cost of the confirmation and discount rate of the LC from the Discounting Bank, minus the costs of

the collateral (cash or 'A' rated bank Standby Letter of Credit / guarantee) they must post for the few days prior to issuance of the instrument to presentation of copy documents) and any other transaction costs.

As well as a source for a Trader of competitively priced funding, the Traders may also use interest rate and fixed / floating swaps with the banks to generate another fully-hedged revenue stream out of the transaction.

3.3.2 The Issuing Bank

Emerging market banks, often in exchange control countries, suffer a high cost of funding in hard currencies, particularly USD. Their central banks often struggle to maintain sufficient foreign currency reserves to meet their USD denominated import requirements, as their economies do not generate enough USD exports. This creates shortages and pricing inflation for FX liquidity, high sovereign risk premiums and a reluctance for international banks lending dollars to their commercial banks.

Emerging market trade finance is typically funded in USD: the international exporter wants to be paid dollars immediately at sight and the emerging market importer needs three to six months or more to receive, condition, distribute and sell the goods in local currency, requiring their emerging market bank to fund USD for the tenor of the underlying cash conversion cycle.

When the emerging market banks attempt to fund these short-term trade dollars, they inevitably find their returns are lower than their cost of equity and are value destroying to their net margin.

Trade Refinance

Under Basel 2 AIRB (Advanced) methodology, sophisticated international lending banks can use lower Loss Given Default (LGDs) for assets designated as 'trade' versus other unsecured lending. This may result in lower RWA capital costs, the benefits of which can be shared with the emerging market borrowing banks in lower pricing.

Also, USD 'trade' financing is not generally regarded as 'wrong way risk' (i.e. it does not increase hard currency exposure to a deteriorating credit obligor or jurisdiction) as it involves a self-liquidating, real flow of hard currency denominated goods into the country.

In most jurisdictions, 'Trade Refi' can only usually be used for large, lumpy, long tenor assets since, to qualify as 'trade' and receive the LGD relief, the borrowing bank must 'prove' its 'trade' by rendering up all the details of the transaction: importer, exporter, goods, tenor, shipping, ports, nominal, and sometimes even copies of some or all of the underlying documents.

This often means that a substantial part of real emerging market trade finance does not qualify as "trade" receiving LGD relief because it consists of a large number of very small, very short tenor, randomly drawn and maturing and revolving assets. Such transactions are therefore often funded at uneconomic, unprofitable rates out of the emerging market banks' Treasuries. They are also very difficult to refinance because the ballistics of these assets make the information marshalling and administration, required by the lending banks to prove they are 'trade', completely impossible.

Structured LC Solution

The attraction of Structured LCs to emerging market Issuing Banks is that they often provide them with an opportunity to obtain trade refinance loans to fund other trade transactions at economically viable rates, without the challenges of data management and operational risk that might otherwise need to be overcome to demonstrate the money is being used for 'trade'.

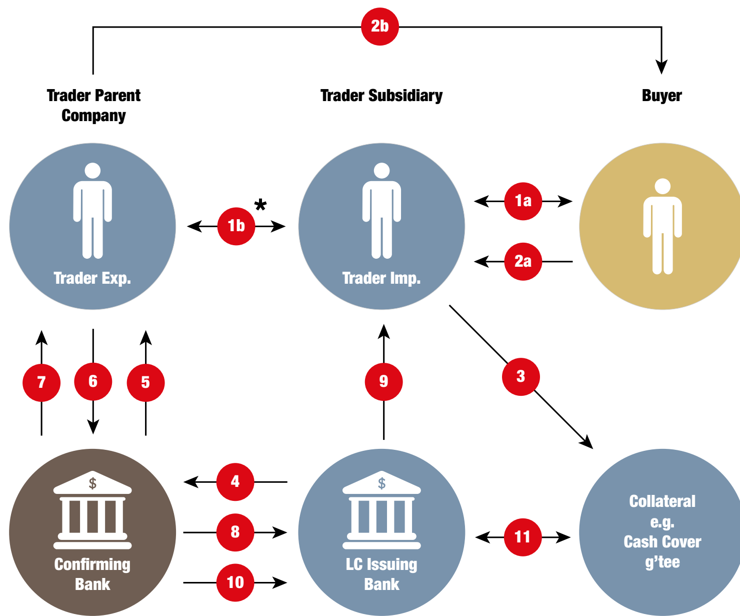
There are variations across jurisdictions and the terms (and circumstances) of each transaction are likely to differ, so any Issuing Bank (and other parties) involved in any particular Structured LC will need to take appropriate advice. However, many transactions to date have proceeded on the basis that the Structured LCs in question qualified as 'trade' for capital purposes because they were based on full disclosure of the LC itself and the relevant documentation. They were not considered RE-finance because the financing bank was a party to the LC instrument.

3.3.3 The Confirming and Discounting Bank

International banks often participate in Structured LCs as Confirming and/or Discounting Banks because the Structured LCs give them access to a shrinking pool of emerging market trade through irrevocable payment obligations of emerging market banks, with good product default characteristics. Structured LC business also provides a conduit for ancillary business with the commodity Traders. Aside from the direct economic benefits of facilitating Structured LCs, there are cross-sell and up-sell opportunities to the Traders and the Issuing Banks through participating in their Structured LC programmes.

4. Example Structure

Flowchart "Structured L/C"



Flow Chart "Structured L/C"

- **1a** Signing of Contract
- **1b** Internal Contract with payment term 180/360 day
- **2a** Payment against...
- **2b** ...presentation of documents / delivery of goods
- **3** Instruction to issue LC with Collateral Cash Cover
- **4** Issuance of the LC
- **5** Advice with adding confirmation
- **6** Presentation of documents (copies)
- **7** Discounting / Negotiation of face value
- **8** Remittance of copy documents
- **9** Notification of utilization of LC
- **10** Debit account issuing bank at maturity
- **11** Issuing bank will debit the local seller at maturity using the cash collateral

5. Legal Issues

5.1 Comparison with non-structured letters of credit

Traditional LCs are frequently used in international trade to satisfy the needs of the seller and the buyer of goods. They are particularly prevalent in trade financing, especially where the two parties are not well known to one another. In its simplest form, a Traditional LC is a contract under which a bank agrees to pay the seller (of goods to be exported) against presentation of specific documents relating to those goods.

The LC is issued at the request of the buyer (the applicant) in favour of the seller (the beneficiary). However, in the majority of Traditional LCs, there are two banks involved, the Issuing Bank and the Confirming Bank. The applicant asks its bank (the Issuing Bank) to issue an LC in favour of the beneficiary. This LC is then sent to the beneficiary's bank (the Nominated /Confirming Bank) who adds its confirmation (giving an additional payment undertaking to the beneficiary upon presentation of documents complying with LC terms).

After collating the required documents, the beneficiary will present the documents to the Confirming Bank. If the presentation complies with the LC, the Confirming Bank will make payment to the beneficiary. The Confirming Bank will then present the documents to the Issuing Bank, which will reimburse the Confirming Bank. The Issuing Bank will then deliver the documents to the applicant against payment.

Once in possession of the documents, the applicant will be able to claim the goods from the shipper. These LCs are used as a "true" trade financing instrument and facilitate trades between two parties, who otherwise may not have been able to transact with one another. Payment under the LC or reimbursement can be deferred by agreement.

Documents to be presented under a Traditional LC are usually originals. Acceptance of non-conforming documents is not automatic.

A Structured LC has a different purpose and structure than a Traditional LC. In a Structured LC, either: (i) the buyer and seller are part of the same group; or (ii) there is an intermediary, who is part of the same group as the seller (i.e. the flow of goods would be seller to an intermediary (seller group company) to the ultimate buyer). It is more common in a Structured LC transaction, for the Issuing Bank and the Confirming Bank not to be in the buyer's / seller's (respectively) jurisdictions, than with a Traditional LC structure.

There are various structures as outlined elsewhere but essentially a Structured LC is used to provide financing to a party in the transaction (quite often the Issuing Bank). Financing the sale and purchase of goods is incidental to the financial nature of the transaction but will, generally speaking, exist as trade between related parties. For this reason, it is very common for copy documents to be used and for the parties to pre-agree the complying presentation and even for the presentation to be achieved at the outset without regard to the movement of the goods.

As an example of a structure for a Structured LC; the applicant (or a group company) would place 100% cash collateral (generated from the sale of goods) for the Structured LC with the Issuing Bank (until maturity of the Structured LC). The Issuing Bank would pay interest on this cash collateral.

The Issuing Bank gets access to term (usually 180-360) funding (by way of the cash collateral), which allows it to issue the Structured LC and it generates a fee from the funding.

The Structured LC would be confirmed and discounted by a Confirming Bank. The seller then presents the documents to the Confirming Bank and is paid earlier by discounting the LC. On maturity, the Issuing Bank reimburses the Confirming Bank. The Confirming Bank generates income from the confirmation / discounting fee(s) it charges. The obligation on the Issuing Bank is to pay under the Structured LC at maturity, which is the same as under a Traditional LC.

If structured correctly, a Structured LC allows (and is intended to) generate a profit for the trader group. This is achieved by ensuring that the interest earnt by the applicant (over the cash collateral) is greater than the interest charged by the Confirming Bank (for

confirming and discounting the Structured LC) to the beneficiary. It is usually important to explain the structure in detail to each bank and the reasons as to what this is intended to achieve. The intention for the trader group companies is to generate a profit for the group.

The main difference between a Traditional LC and a Structured LC is that a Traditional LC transaction is intended to assist a transaction with its only purpose to facilitate the sale and purchase of goods, from a seller to an un-associated buyer. A Structured LC transaction is set up usually between companies in the same group, to generate a group profit from that transaction. At the same time the Issuing Bank has the benefit of funding so long as it agrees to pay the Structured LC at maturity.

5.2 Case Law

A review of reported case law in various jurisdictions (US, China and Singapore) suggests that Traditional LCs and Structured LCs will not generally be treated differently with regards to their validity and enforcement. This is, however, subject to certain caveats. The leading U.S. Supreme Court of New York case of Fortis Bank (Nederland) N.V. v Abu Dhabi Islamic Bank highlighted the independence of LCs from the underlying transactions, whether they be Structured LCs or Traditional LCs. This was a case in which a Confirming Bank refused to reimburse a negotiating bank claiming fraud on the part of the Issuing Bank which had issued a Structured LC. The court rejected this argument and concluded that the synthetic nature of an LC does not make it fraudulent and stating further that a Structured LC's 'novel' and 'unusual' nature does not allow for the setting aside of payment obligations due to fraud, simply because of the chosen structure. A caveat emerges, however, as the reason for the judges' finding was that all parties were shown to be aware of the synthetic nature of the transaction and the reasons for which this structure was entered into, concluding that there was no element of fraud. It is, therefore, prudent to ensure that all parties are aware of the role of the Structured LC in a transaction and that it is adequately documented in line with the provisions of UCP 600.

Whilst not a Structured LC as such, a further case went to the high court of Singapore in 2006, between Raiffeisenbank Zentralbank Osterreich AG ("RZB") and Archer Daniels Midland Co. (and some of its subsidiaries) ("ADM"). The structured trade transaction used Promissory Notes instead of an LC, but nevertheless relied on utilising commodity flows initially arising between the ADM entities, against which the Promissory Notes were issued. When Parmalat collapsed it defaulted on some of the Promissory Notes which RZB had purchased. RZB took ADM to court claiming that the structure was fraudulent as, amongst other things, the title to the relevant goods did not flow sequentially as the final buyer paid for the goods before the Promissory Notes were discounted. Ultimately, the court found in favour of ADM. This was principally on the basis that the real nature of the transaction was known to RZB, as it had seen the related bills of lading and was purchasing Promissory Notes at a discount based on there being valid instruments and the credit risk of Parmalat. In this case, the Promissory Notes were valid and the risk of Parmalat not paying was one it had accepted.

Another example is the Chinese Supreme Court's review of thirty cases involving similar facts. In the case of ANZ Bank, Shanghai Branch v. Ningbo Haitian International Trade Co. the court ruled that the bank had not negotiated in good faith and the Structured LCs were fraudulent. The court's reasoning was tied to the nature of the transactions funded by the Structured LC and their view was that the Structured LC was a tool for financing as opposed to being used as payment for trade, lacking valid underlying transactions. The court concluded that ANZ had planned the use of the Structured LCs as a financing arrangement for their client and despite their inability to prove the Bank's direct involvement in fraud, the Structured LCs could not be upheld as valid instruments of a bona fide negotiation for lack of legitimate underlying transactions.

Although there is no firmly established English case law guidance on the treatment of Structured LCs as against that of Traditional LCs, the above case law suggests that Structured LCs are likely to be enforced in the same way as Traditional LCs, provided that the Structured LC is documented in line with UCP 600, that all parties to the transaction are aware and informed of its nature and purpose and that it supports a valid underlying trade transaction. As affirmed by the Supreme Court of China in the case of ANZ Bank v Ningbo, the fact that the underlying trade transaction is between group companies does not change this argument.

6. Anti-Money Laundering and Compliance Issues

When conducting any trade finance related transaction banks must conduct the required Know Your Customer (KYC), Anti-Money Laundering (AML), Sanctions and other controls as defined by the Finance Providers' risk approach. Detailed guidance on KYC, AML and sanctions requirements is available in separate industry documents, notably:

- the Wolfsberg Group, ICC and BAFT Trade Finance Principles (2019 amendment). The publication provides a guideline for the management of financial crime risks;

- the Wolfsberg Guidance on Sanctions Screening (2019)which guides Financial Institutions as they assess the effectiveness of their sanctions screening controls; and

- the Wolfsberg Anti-Money Laundering Principles for Correspondent Banking.

These guidelines highlight the responsibilities of the banks involved in trade transactions to have a good knowledge of their customer or instructing party, the business that they conduct and with whom and where they are located. Furthermore, it emphasises the need for banks to follow the regulations, which are aimed at detecting and preventing: money laundering; financing of terrorists or terrorist organisations; committing or assisting in bribery and corruption; tax evasion; the proliferation of weapons of mass destruction: and other financial crimes or sanction breaches.

When considering Structured LCs, the aforementioned requirements are as applicable to these structures as they are in Traditional LCs or any other trade transaction. The key to managing compliance risk in any trade finance structure is to ensure that the details of the transactions are fully understood. This involves having a good knowledge of:

- Their customer or instructing party, including full KYC information.
- The business that they conduct and with whom and where they are situated.
- Whether the goods, parties, and source or destination countries covered by international AML or sanction rules?
- Whether the goods are dual-use or have environmental or other reputational aspects to be considered?
- Whether the nature of the transaction is fully understood and makes sense in the context of the client's business?

Some banks do participate in Structured LCs but only with long-standing clients and under very specific conditions. Once a decision is taken to proceed with Structured LCs, the key mitigant is to know your customer and specifying under which circumstances you will participate in Structured LCs.

Key considerations include: choosing to work with clients who are well known and respected in their markets, who understand their business who have a strong and proven track record in respect of managing their business and with whom the bank has a strong relationship. In addition, ensuring there is full transparency and undertakings as to how they transact their business. Alongside this, ensuring the requirements of the various industry guidelines and regulations are being met in the normal course of business is critical.

7. Risk

This section concentrates on the risk involved when dealing with Structured LCs from a Confirming Bank's point of view. Risk in this sense refers to the Credit Risk and not the AML / KYC risk, operative risk, reputational risk or fraud risk.

The following issues and considerations must have been resolved to the satisfaction of the Confirming and Discounting Bank:

1. The nature of the transaction is fully understood and makes sense in the context of the client's business.

2. The LC Issuing Banks, as well as the Commodity Traders involved in the Structured LCs, are considered experienced market participants with a proven track record of handling trade finance operations. This implies that both maintain a longstanding relationship with the involved business partners.

3. Local regulation does not forbid the issuing of Structured LCs.

4. Since there are many structures in the market, for the purpose of this guide we only analyse the risk of "plain vanilla" Structured LCs (see section 2, Glossary of Terms).

5. This section is not intended to give a definitive risk evaluation of Structured LCs. Each institution will have to make its own critical evaluation to base its own risk decision on.

For the purposes of this section, Credit Risk has been divided into two components that are discussed as the following: on the one hand as "counterparty risk" (intrinsic to the LC Issuing Bank) and on the other hand as "transfer risk" regarding the foreign currency availability for the LC Issuing Bank or for the country this bank is located in and possible exchange controls in place.

Finally, we add some considerations regarding the potential derivative risks of Structured LCs.

Counterparty Risk

This includes the general credit risk defined by the bank's capital and liquidity ratios. A classic balance sheet analysis will define the risk rating of the LC Issuing Bank. In turn each Confirming Bank will make its own assessment in line with internal credit policies with some banks having more risk appetite for certain geographies and counterparties than others. Further, considering that the Issuing Bank receives foreign currency financing, the risk also depends on the bank's access to the foreign currency amount as the discounted LC needs to be repaid at maturity. Is the operation "self-liquidating" by the underlying trade transaction (i.e. by receiving export income)? If that is the case, the foreign currency risk may be considered limited. Therefore, depending on the importance of this risk in the credit analysis, the structure of the LC can be taken into account regarding the likelihood of self-liquidation.

Look at the underlying trade flows. In case the goods do not travel from the LC Issuing Bank's country, self-liquidation is less likely as export income will be earned in another country. In case it is an import to the country of the LC Issuing Bank, the question is how much foreign currency may be raised by selling the goods in the importer's country? If neither is the case, the question is if the financing can be considered as a traditional trade financing at all from the point of view of the LC Issuing Bank?

As indicated in parts of this guidance, many market participants consider Structured LCs as a means to obtain working capital financing, and not as a traditional trade finance transaction. Several characteristics of the structured LC (such as the purpose of the LC, trade flow, payment / pre-payment of the LC by the importer, copy documents, the tenor of financing in comparison to the life-time of the merchandise etc.) may support this point of view. If a bank's credit department takes this point of view, the respective internal risk considerations for working capital will apply.

A much debated topic is whether Structured LCs will be treated pari passu to Traditional LCs in an insolvency or wind up of the Issuing Bank. There is anecdotal "evidence" supporting both views, e.g. Structured LCs receive the same preferential treatment as trade or they do not and are ranked junior to other trade finance creditors.

Transfer Risk

As the financing obtained under a Structured LC is in foreign currency, it is necessary to consider the transfer risk lying outside of the Issuing Bank's own ability to generate or dispose of foreign currency. There are two scenarios to be considered here:

(i) The Issuing Bank is taken over by its regulator and subsequently dissolved (e.g. for insolvency).

(ii) The country of jurisdiction of the Issuing Bank introduces a foreign currency regime and therefore needs to decide which of the banking system's obligations are to be paid or not.

In both cases it is very useful to understand the regulator's position towards Structured LCs, if they have one. The above considerations regarding the real trade flow as well as specific characteristics of the Structured LCs as potential working capital financing may influence the regulator's position to support the (privileged) payment / honouring of Structured LCs under the two scenarios (i) and (ii).

Potential Derivative Risks of Structured LCs

Although not observed in commodity markets to date, there is always a potential risk where transactions may become wholly synthetic (i.e. divorced from the underlying transaction in physical goods). Where no underlying physical goods are involved in the transaction (which should not be the case as pointed out above), it can become derivative and no longer a hedge for a physical position. This issue is not only relevant to the markets in the commodities of the underlying contracts but also the currencies of such contracts. Therefore, it should be recognised that if structured LCs are used to form the basis of other trading transactions, such transactions may not be linked directly to the underlying physical trade and may become speculative. Further, should Structured LCs (without a direct link to the underlying goods) come to play a significant role in wider finance, the classic "bubble" risk is always present as history has shown. To date, Structured LCs have not appeared to give rise to such risks in the commodities markets or drawn the attention of commodities derivatives regulators. However, steps recently taken by one central bank indicate that where the pricing and settlement currencies of transactions are not identical issues may arise. It is important, therefore, to identify this as a potential risk and that participants are mindful of the significance of the link and the role of underlying physical goods and contract in such transactions.

Another aspect of derivative risk that could be associated with Structured LCs arises out of participants' hedging strategies. Risk and hedging managers need to be mindful that actual physical trades and trading volumes are properly identified so that any potential futures position is appropriately linked to physical trades or properly identified as an open position. It is, therefore, important that risk managers understand the nature of Structured LCs and their link to underlying physical goods and that multiple counting of the same goods (in the physical trade itself and within the Structured LC) does not occur.

8. Acknowledgements

ITFA would specifically like to thank the following members of the Working Group for their contributions:

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