Fraud in letter of credit transactions: The experience of Malaysian bankers

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Abstract

This paper explores the issue of fraud in letter of credit (LC) transactions in Malaysia. We explore the common modus operandi used by fraudsters in LC transactions and highlight the various actions taken by banks when dealing with forged LC documents and fraudulent goods. We find that although the phenomenon of fraud in LC arrangements in Malaysia is marginal, banks have indeed experienced fraud in LC dealings. Banks actions are firmly guided by the Uniform Customs and Practice (UCP) for Documentary Credits, which clearly affirms that banks must honour payment to the seller upon full compliance of the LC requirements. Findings reveal that banks adhere to the UCP guidelines despite being presented with falsified documents that cannot be fully proven or even when there is a possibility that substandard goods are being transacted. Finally, recommendations on how banks can mitigate these problems are offered.

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Keywords: Letter of credit; Fraud; Malaysian banks
1. Introduction

A letter of credit (LC) is an instrument that is commonly used to facilitate payments in business transactions between buyers and sellers, and can be used either locally or across borders. LCs, which are governed by the Uniform Customs and Practice (UCP) and formulated by the International Chamber of Commerce’s (ICC) Commission on Banking and Practice, are a mechanism in which the bank acts as the paymaster on behalf of the purchaser by executing payment to the seller; conditional on compliance of the seller’s documents to the LC terms (Article 5, UCP 600). Since the disbursement of funds is solely based on the conformity of documents to the LC requirements, the window of opportunity for committing fraud is left ajar and may be exploited by irresponsible parties involved in the trade. If, for example, a fictitious contract submitted to a bank goes undetected, the bank will issue the LC after receiving confirmation from its customer that the deal is credible. When documents are presented to the bank to be checked against requirements of the LC, the bank merely needs to ensure that all documents are in order and fulfil all LC conditions (Article 14, UCP 600). The bank is, however, under no obligation to verify the authenticity of documents or the signatures thereon, as specified in the UCP 600 (2007). Therefore, in such cases, there is a possibility that wrongful payment will be made to the seller. Article 34 of the UCP 600 clearly asserts that the bank is not liable for falsification of documents or goods being traded under the LC, as stated below:

“A bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document, or for the general or particular conditions stipulated in a document or superimposed thereon; nor does it assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods, services or other performance represented by any document, or for the good faith or acts or omissions, solvency, performance or standing of the consignor, the carrier, the forwarder, the consignee or the insurer of the goods or any other person.”

Fraud in LC transactions can be committed either by the seller, buyer or financial intermediary (Curtin, 1987). Among these, fraud committed by the seller is said to be the most prevalent (Lee, 2009; Miller, 1959), leaving devastating effects on the purchaser. Such situation is described by the Director of International Commercial Crime, as follows:

“False documents that comply with LC terms are presented by the seller to the bank. The confirming bank then pays and sends the documents to the issuing bank. The buyer believes that the cargo has been loaded and is on its way to its destination. In many cases, it is only when the vessel is due to arrive at the destination port that the buyer discovers that the cargo, as contracted, has not been loaded on board. He has paid for the deal but is put under spurious documents.”

As noted above, fraud committed by the seller via LC transactions will have adverse effects on the buyer, since the buyer is still under obligation to repay the bank for credit facilities that

\[^2\text{The UCP is a body of Articles which regulate the implementation and operation of LC. Its existence witnessed the best effort of the International Chamber of Commerce (ICC) to produce this valuable work which was first published in 1933. The latest version is the UCP 600 was implemented on 1st July 2007. Even though UCP has no force of law, it is applied in almost all transactions involving LC.}\]
have been disbursed, although he has received faulty or no goods at all (McCormack, 2000). Court cases in Malaysia reveal that fraud cases involving LC transactions follow a similar modus operandi. However, it has been noted that there is very limited academic research on the issue of LC fraud in the context of Malaysia.

Given the lack of literature in the Malaysian context, the current study is conducted with four (4) main objectives. First, we explore the issue of LC fraud by examining its severity extent based on the experiences of local bankers. Second, we investigate the common modus operandi undertaken by fraudsters. Thirdly, we investigate and highlight the actions taken by Malaysian banks in dealing with such cases. Lastly, we offer recommendations that can potentially mitigate the problem of fraud in LC transactions.

This study is significant in several ways. First, the issues to be highlighted in this paper will create awareness regarding the adverse risks of international trade conducted via LCs. Since this issue is rarely discussed in public, greater awareness will safeguard potential LC applicants from being deceived by perpetrators. In addition, findings of the study revealing the common modus operandi committed by fraudsters enable the recommendation of possible reforms that can be undertaken. Lastly, this study fills the gaps in the local literature since most past research are conducted in western countries and it has been noted that this issue has received little research interest in Malaysia.

The rest of this paper is structured in the following manner. Section 2 explains the methodology undertaken. Section 3 presents the findings on LC fraud occurrence in Malaysia, from the perspective of Malaysian bankers. Section 4 provides a discussion on the issues and presents several recommendations that may be applied by banks and relevant parties. Section 5 concludes the paper.

2. Methodology

2.1. Data

In Malaysia, there are no readily available statistics representing specific data on LC fraud. Hence, we explore the issues in hand by employing a qualitative method of data collection via face-to-face interviews with bankers and LC experts, as shown in Table 1.

As can be observed in Table 1, a total of twenty (20) interviews were conducted from year 2010–2011. The majority of respondents were Malaysian commercial bankers, while some were trainers and academicians. Since there is no specific requirement for the number of respondents in qualitative research, the respondents were selected based on certain criteria such

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3Requests for LC fraud statistics were forwarded to the Central Bank of Malaysia, Malaysian Commercial Banks, Malaysian Royal Police and other relevant governmental and non-governmental bodies but, notwithstanding the banker’s secrecy or confidentiality, no statistics on LC fraud are specifically reported by these institutions. However, the statistic of fraud crimes is provided by the Royal Police of Malaysia which includes commercial fraud on ATM card, lucky draw and credit card scams, etc.

4“ar to provide some idea of the scale of qualitative investigation one might expect to achieve between 20 and 50 interviews for a one-to-one investigation and around 60 to 100 participants at group interview, depending on the research question.” Wilmot, A. (2005), Designing sampling strategies for qualitative social research: with particular reference to the Office for National Statistics’ Qualitative Respondent Register, via Google <www.statistics.gov.uk/about/services/dcm/downloads/AW_Sampling.pdf>, viewed 1 Feb, 2010. In addition, Mann (1999) used 10 bankers who engage in LC transactions in his study on discrepancies in LC transaction.
as their position, experience in LCs and accessibility. We also interviewed the Director of the International Maritime Bureau (IMB)\(^5\) to obtain his insights and opinions. Though the sample of respondents is not large considering the small number of LC experts in Malaysia, this study consists of the views presented by key persons who are directly involved in LC affairs. Most respondents held the position of Head of Trade Finance Department in Malaysian commercial banks and had more than 11 years of experience in LC trade. In addition, some of the respondents were experts in LC transactions and are known in the field through their numerous training and seminar programs on LC issues. Thus, the credibility of the study has been achieved by including these professional and intellectually qualified respondents. The initial contacts with respondents were made through phone calls and emails, followed by the interview. For confidentiality and ethical reasons, the names of the respondents and the respective financial institutions are not disclosed in this paper.

This study used semi-structured interviews whereby the respondents were taken through a particular sequencing of questions to respond to. Questions were structured and drafted based on information gathered from the review of literature on the subject. Where appropriate, the researcher conducted informal interviews to obtain information on experiences, opinions, attitudes, feelings or perceptions (Sekaran, 2003; Yaqin, 2007). We leverage on this method and maximize the opportunity to unravel as much information as possible from the experiences of Malaysian bankers in regards to the subject matter. The main advantage of a face-to-face

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\(^5\)“The IMB is a non-profit making organization, established in 1981 to act as a focal point in the fight against all types of maritime crime and malpractice,” International Maritime Bureau, International Chamber of Commerce via Google <http://www.icc-ccs.org/> viewed on 19 May, 2011. “The IMB is a specialised division under the Commercial Crime Service(CCS) underneath the International Chamber of Commerce (ICC), which looks into shipping and trade and trade finance fraud.” Mr. Pottengal Mukundan, Director of International Maritime Bureau (IMB), London.
interview is the ability to modify the questions based on the comments given by the respondents in order to make the questions clearer and easier for the respondents to respond to (Salkind, 2009). In addition to interviews, information was also collected through training programmes, workshops, seminars and conferences on LC (Patton, 1990).

3. Findings

3.1. The severity of LC fraud in Malaysia

The first objective of this paper is to explore the severity of LC fraud in Malaysia. We addressed this issue by asking bank officers and LC experts how often they had come across cases of fraudulent LCs in their institutions. Based on the responses given by the respondents, the occurrence of fraud in LC transactions was generally perceived as mild and rather rare. One banker commented:

“In terms of percentage, we rarely come across fraud cases. The occurrence of LC fraud is very, very low. I can confidently tell you that in banking the highest fraud cases will be in regards to credit card and the lowest involve LC.”

However, an expert on LC remarked somewhat differently when asked about the issue:

“It is difficult to be specific, I probably can’t estimate. But I don’t see any reason why the situation in Malaysia should be any different from any other parts of the world because fraudsters exist in every country. All commercial centres will have about the same proportion of crooks that you would have anywhere else. So, in Dubai, London and Hong Kong, there will be larger numbers because the volume is higher but the proportion is exactly the same. In Malaysia too, there has been some major fraud in the past.”

The divergent views presented above lead us to further explore the validity of these statements by examining the statements of respondents in regards to the types of LC fraud experienced by bankers, as discussed in Section 3.2 below.

3.2. Types of LC fraud

We tabulate the various types of LC fraud as experienced by the bankers, as shown in Table 2. From a total of twenty (20) respondents, fourteen (14) bankers revealed that documentary fraud was the most prevalent. Meanwhile, container and insurance fraud appeared to be less serious, as only five (5) and one (1) respondent(s), respectively, claimed to have across those types of fraud cases.

Documentary fraud is reported to be on the rise during financial and economic crisis where fraudsters may make use of LCs to obtain financing from the bank for non-existing cargo. It

Table 2
Types of fraud as perceived by Malaysian bankers.

<table>
<thead>
<tr>
<th>Types of LC fraud</th>
<th>Frequency (n = 20)</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Documentary fraud</td>
<td>14</td>
<td>70</td>
</tr>
<tr>
<td>Container fraud</td>
<td>5</td>
<td>25</td>
</tr>
<tr>
<td>Insurance fraud</td>
<td>1</td>
<td>5</td>
</tr>
</tbody>
</table>
appears that fraud cases in LC operations are quite rampant in the current adverse economic conditions. In this regards, the risks faced by banks are inherently high especially once payment has been released. This is reflected in a statement by an expert in LCs:

“It can be a bit risky to the bank. For example, if the seller is a fraudster, he presents documents which are all forged to the bank. When the bank examines documents, the documents at the face look as if they are in compliance, that everything is in order. The bank can’t say anything, they have to pay.”

As noted from Table 1, the respondents revealed that fraud in regards to insurance on goods was also a problem in LC transactions. The most basic form of cargo insurance fraud was reported as over-insurance on goods (Conway, 1990). The seller of the goods would insure the goods at an amount higher than its actual value, fabricate an occurrence of loss or spoilage, and then claim from the insurance company an amount higher than the actual value. This way, the seller would profit from the insurance proceeds.

The third type of fraud mentioned by respondents was container fraud. This kind of fraud normally occurs when the seller ships fraudulent goods to the purchaser. We further discuss this in Section 3.4.

Thus far, we can deduce that the LC fraud climate in Malaysia is perceived to be mild. However, in cases that it does occur, documentary fraud is viewed to be the most common, followed by container and insurance fraud. For the purpose of this paper, we will focus only on documentary and container fraud as these types of fraud have more serious implications on banks.

3.3. Fraudulent documentation of LCs: modus operandi

Next, we deal with the second objective of this paper, which is to investigate the common modus operandi undertaken by fraudsters. According to responses from the bankers, among the types of scams in LC fraud cases were presentation of forged documents (e.g. bills of lading, delivery order and invoices); fraud conspired by the buyer and/or seller; and fraud perpetrated by a third party (e.g. the shipping agent).6 Other types of modus operandi that were used involved using LCs as an instrument for money laundering7 and internal fraud.8

As shown in Table 3, 45% of bankers perceived that forgery of bills of lading were the most common modus operandi in LC fraud. A bill of lading is a document of title or ownership to the goods and by nature is negotiable (Article 20, UCP 600). Fraudsters might forge the bill of lading and sell the cargo to someone else, or fabricate the authenticity of a non-existent cargo. In such cases, the bank would be misled into believing that the cargo exists, when actually it does not. As explained by a banker:

“The most notorious fraud is documentary fraud. It is always involves bills of lading in international trade transactions. For example, a bill of lading is forged by a third party,

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6For example, a bill of lading is forged by a third party, normally the shipping agent. See United City Merchant Investment v Royal Bank of Canada [1983] 1 AC 168, per Lord Diplock, at 178.
7Money laundering is defined by Section 3 of the Anti-Money Laundering Act (AMLA) 2001 as “any act which acquires, receives, possesses, disguises, transfers, converts, exchanges or removes from or brings into Malaysia proceeds of any unlawful activity.” Any transactions which involve an unlawful act such as drug money or money derived from crime or criminal acts are amount to money laundering.
8Fraud conspired by employees of the bank.
normally the shipping company... whereas in domestic trade, fraud always occurs via delivery orders and invoices issued by suppliers, with intention of cheating the bank.”

While bills of lading are usually required in international trading LCs, delivery orders are used in domestic trade transactions (Todd, 2007). In local transactions, both contracting parties are domiciled in Peninsular Malaysia, and goods are transported via land. Delivery orders serve as documentary evidence for cargo delivery from a seller to the buyer (Mahayuddin, 1997). As explained by one interviewee with expertise in LCs:

“Although a delivery order is not a document of title, it has served well in the Malaysian commerce system. It is very much similar to an invoice whereby it is issued by the beneficiary addressed to the applicant. Upon delivery, the applicant is required to acknowledge receipt of the cargo and the beneficiary will present the acknowledged delivery order bearing original signature of the applicant to the bank for negotiation.”

Being a widely used document in local trade, the inherent risks of delivery orders are high since they are issued by the beneficiary himself rather than a third party. This creates an opportunity for malicious acts of fraudulent collaborations to occur. The collaboration to commit fraud is particularly untraceable if the trade transaction takes place between subsidiary companies or companies that share common directorship. Therefore, banks will take extra precaution when checking delivery orders as opposed to other documents since this document entails higher risk. In situations where delivery orders are used in transactions, confirmation of receipt from the applicant would enable the detection of potential fraud as it provides evidence of the delivery and receipt of goods.

From the interviews conducted, Malaysian bankers generally admit that fraud is more easily committed in local LC transactions as opposed to international LCs. Although local and international LCs function in a similar manner (that is, to prove that the goods are in order), bills of lading are documents of title indicating ownership of goods whereas delivery orders merely function as invoices. This view was clearly stated by one of the interviewees:

“Fraud always occur in local LCs as delivery orders are used and signed by the applicant... and he acknowledges that the goods are in order. On the other hand, international LCs using bills of lading issued by a shipping company are more reliable as all the shipping companies must first be registered with International Maritime Bureau (IMB).”

The ease at which delivery order can be created provides a scrupulous opportunity for two pretentious parties to act as buyer and seller and conspire to cheat the bank. A fake delivery order...

Table 3
Experience of Malaysian bankers: LC modus operandi.

<table>
<thead>
<tr>
<th>Types of modus operandi</th>
<th>Frequency$^a$ ($n = 20$)</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forged bills of lading</td>
<td>9</td>
<td>45</td>
</tr>
<tr>
<td>Forged delivery order</td>
<td>6</td>
<td>30</td>
</tr>
<tr>
<td>Conspiracy between buyer and seller</td>
<td>6</td>
<td>30</td>
</tr>
<tr>
<td>Third party</td>
<td>4</td>
<td>20</td>
</tr>
<tr>
<td>Instrument for money</td>
<td>2</td>
<td>10</td>
</tr>
<tr>
<td>Internal fraudster</td>
<td>2</td>
<td>10</td>
</tr>
</tbody>
</table>

$^a$ The total frequency does not add up to twenty (20) because the responses are not mutually exclusive — one respondent may have provided more than one response.
order may be issued by the one party acting as “seller” and signed by another party acting as the “buyer” who would forward the delivery order to the issuing bank for confirmation. The bank, being totally unaware of the bogus sale, would then release payment to the pretentious seller who would later split the funds with the supposed buyer.

On the other hand, bills of lading used in international trade can only be issued by a shipping company, hence, are more reliable and less susceptible to fraud risk since all shipping companies are registered with the IMB (Mukundan, 2010). Because of the riskier nature of delivery orders in local LC transactions, most banks in Malaysia are usually sceptical and rather prejudicial to local LCs. Slight discrepancies found in documents drawn under local LCs are usually viewed as an early warning signal for potential fraud.

3.4. Banks’ action on suspected fraud

3.4.1. Fraudulent documents

As per the third objective of the paper, we next explored the actions that banks would take once fraud is detected in an LC transaction. Results revealed that banks might react in several ways. Usually, an initial investigation would first be conducted before further action was taken. The following statement was expressed by one of the interviewed bankers:

“Applying the prudent approach concept, banks will first need to validate the news and will perform its own investigations… that is, by liaising and checking with the relevant parties such as the local authorities, banking regulators, and banking associations....”

The approach expressed above was generally agreed upon by other respondents. The prudent approach mentioned by the above banker implies a due diligence approach or the most proper approach which should be considered by a banker in dealing with fraudulent documents. Another interviewee explained that upon detection of possible fraud, the credit officer handling the suspected client would be alerted, so that further investigations could be carried out. All transactions relating that particular customer would be frozen pending full investigation and detailed feedback from the credit officer.

Nonetheless, it should be emphasized that prior to cancellation of the client’s facilities, the bank must have solid evidence that actual fraud had been committed. Otherwise, the bank may be susceptible to risk of being sued by the customer. This view was articulated by one of the respondents:

“If bankers know of the fraud before the documents are sent to the issuing bank, they may not want to handle the documents… they may cancel all the credit lines or other facilities, but still they have to prove the case. Otherwise, the customer can sue the bank for wrongfully ceasing the line of credit.”

As earlier discussed, if the allegation of fraud is found to be valid, banks would first cancel the facilities by freezing the customer’s account, and, if necessary, lodge a police report. It was agreed by majority of bankers that in cases of suspected fraud on documents, bankers would always countercheck with the customer and act according to the provisions of the UCP. However, if the existence of fraud comes to the bank’s knowledge prior to release of the payment and the case is proven, the bank may immediately dishonour the payment to the seller.

In certain cases, banks would seek mediation from the IMB for further confirmation of the alleged fraud, by forwarding all reports of the investigation including the dubious bill of lading and details of the customer suspected of fraud. In our interview with the Director of IMB, he mentioned that:
“Some of the transactions are very complex. It is very difficult for the bank to really control this type of fraud. One of the ways to counter this problem is by the service we offer them, which is [the] verification of [the] bill of lading. The principle behind this is, in trade transactions, the bank is financing the cargo which has been shipped on board a vessel bound for the stated consignee and that fact is what needs to be verified. If that is verified then the transaction is valid. We are focussing exactly on this verification. We receive the bill of lading from the bank and we will verify if the cargo went on board the ship and is bound for the consignee. Then, the bank will know whether their clients are telling them the truth or not.”

If the existence of fraud is confirmed by the IMB, the customer would be referred to them for further action. However, as can be noted in Table 4, this course of action was not rather favourable as only two (2) out of twenty (20) bankers claimed to use the services of IMB. Results of the interviews revealed that most banks preferred not to use this service due to the high service charges imposed by the IMB.9 As an alternative, banks would usually advise the client to resort to legal proceedings or report the case to their legal department or Relationship Manager for further investigation.

3.4.2. The case of fraudulent goods

We further explored the actions that banks would take in situations that involved discrepancies in the goods being traded, rather than discrepancies in the documents. Results are tabulated in Table 5. It can be noted that fifteen (15) respondents indicated halting payment under the LC only if the customer obtained a court’s injunction. Thirteen (13) bankers also highlighted that they had to make payment upon compliance of the documents. Further, ten (10) respondents claimed that they would leave the matter in the hands of the two trading parties.

In situations where LC documents were in perfect order but defective or fraudulent goods were delivered by the seller to the purchaser, bankers would usually abstain themselves from getting involved. The UCP, in fact, clearly recommends that banks limit their involvement from disputes of this nature. Thus, if it is brought to bank’s attention that a seller had intentionally shipped either defective, wrong or inferior quality goods despite perfect compliance to the LC terms, the bank would nonetheless release payment to the seller (Harfield, 1972; Daihuisen, 2000). The only way for the buyer to stop payment is by obtaining an injunction against the payment, as clearly explained by one respondent:

“Banks deal with documents and we are not in any position to determine if such an allegation is true or not. Applicants will need to apply for court injunction to stop the bank from honouring their obligation under the LC.”

9“The fee is part of membership and the cost of checking a bill of lading is around GBP £20 to GBP £25.” Mr. Mukundan, Director of International Maritime Bureau (IMB), London.
As shown in Table 4, in cases of LC fraud where the dispute concerns fraudulent goods, bankers would prefer leave the matter in the hands of the transacting parties so that they resolved the dispute among themselves. The banks would still honour payment as long as the documentation was in compliance to the LC terms. This notion was emphasized by one banker: “As far as the bank is concerned, we do not get involved with fraud on the goods and would let the parties resolve the dispute among themselves. Likewise, banks are not willing to get involved with court procedures unless they are sued by an applicant.”

On a positive note, the interviews revealed that cases of fraud involving defective goods are, in practice, very rare and even in such cases parties to the transaction would usually settle the dispute among themselves without involving the bank. In some cases, the buyer might be willing to accept the defective goods since the goods are viewed to be very important to them or were difficult to be obtained locally. In such cases, the LC transaction would be abandoned and the buyer would settle the amount to the seller under special arrangements (for example, at a discounted price) and/or via other methods such as documentary collection, cash or transfer telegraph.

Having presented the evidence on LC fraud from the experiences of Malaysian bankers, we proceed by discussing these issues and their implications in Section 4. We also provide recommendations that may help mitigate the problem.

### 4. Discussion and recommendations

From the results presented above, it can be concluded that the Malaysian bankers interviewed in this study fully adhered to the autonomous nature of LC as provided by the UCP. By strictly observing the provisions of the UCP, banks would refrain themselves from getting involved in cases relating to fraud in LC transactions. As required by the UCP, documents are only examined at face value — as long as they are in compliance with requirements of the LC, bankers would honour their duty in executing payment to the seller (i.e. the beneficiary) regardless of the actual existence or condition of the goods. Any allegations of fraud are cautiously dealt with by taking the steps as mentioned in Section 3.3 above.

Based on results of the study, we find that two conspicuous problems exist in the dealing of LC fraud. The first is the limitation of UCP provisions, which appear to be extremely brief, narrow and general in nature, therefore leaving gaps of ambiguities to be present when cases of LC fraud are required to be dealt with (Ulp, 2007; Barnes and Byrne, 2007). The scope of the UCP is apparently restricted to only fraud on documents, leaving significant grey areas in dealing with cases involving fraudulent goods (Buckley and Gao, 2008). Perhaps the only provision regarding fraudulent goods is a disclaimer that merely protects bankers, possibly
allowing scrupulous fraudsters escape without being prosecuted, leaving potential victims of fraud bearing the consequences of the misfortune.

Hence, it is suggested that the UCP be re-examined to include clear guidelines on how fraud cases are to be dealt with. This need is particularly important in international trade disputes, as these types of cases are usually left to be interpreted and decided on by national courts. The UCP provision should insist on giving fair treatment to both bankers and its customers, rather than prioritizing the rights of the bank. When faced with cases here fraudulent goods have been transacted, the UCP should allow banks to act at their discretion and halt payment should discrepancies be found in the condition of goods. This, however, should be enforced with care whereby instructions and consent from the customer must be obtained prior to such decisions.

The second problem observed from this study is the inability of domestic law to deal with fraudulent LC cases, in regards to the punishment to the perpetrator. LC transactions are very technical and their handlings are difficult in the perspective of domestic law (Byrne, 2006). In most cases, fraudsters easily escape as the existence of fraud is usually difficult to prove. Usually, it is the victims who are at the losing end while the fraudsters get away after receiving hefty payment from the bank. In Malaysia, the Penal Code (Act 574) offers legal provisions on the mode of punishments for all criminal offences. Since fraud in LC transactions or documentary fraud is considered a criminal offence, its punishment is governed by the Penal Code. On the other hand, the UCP is general in nature and has no legal enforcement. Though the application of the UCP is worldwide, it is not recognised as a statute that can be enforced in domestic courts. Thus, one possible but realistically challenging solution to this issue is the inclusion of specific provisions in the UCP relating to fraudulent LC documents that can provide clearer guidelines to local law enforcers on the punishment of LC fraudsters.

Nonetheless, the study has found that banks that have no experience in LC fraud cases emphasized on the adoption of thorough and stringent screening procedures when dealing with LC applications. Such rigorous approach is deemed necessary in order to avoid potential problems in the future, particularly the failure to detect forgery in documents. This may especially be true in view of advances in printing technology that allow easy fabrication of documents which may be perceived to be legitimate in the eyes of an unsuspecting banker. Hence, a probable approach to be taken by banks is to apply the principle of KYC or “know your customer” prior to the approval of any LC application, whereby applicants must already be an account holder of the bank, and hold credit facilities such as overdraft or fixed loan. Existing customers would have already satisfied the credit and legal screening process conducted by the Credit Department and would have built credible track records with the bank. In addition, customers with credit facilities are usually subject to yearly reviews that enable early detection of problems by the bank. Thus, when dealing with customers with good track records, banks will feel more secured when issuing and disbursing funds under the LC.

The feedback obtained from the interviews suggests that despite being recognized as the most common occurrence in LC fraud, forged LC documents are in practice rarely experienced by Malaysian bankers. This is partly because banks are governed by policies and guidelines set by the Central Bank and the Association of Banks in Malaysia (ABM). As explained earlier, banks apply stringent procedures to mitigate the risks of customer default and minimize the occurrence of non-performing loans. At the same time, banks must always act based on the rule of good faith and uphold its honour in disbursing payment upon compliance of the LC terms and conditions.

Another risk mitigation measure that may be adopted by Malaysian banks is to keep abreast with the economic condition and political situations of foreign countries. The Central Bank issues periodical circulars to inform of the accepted and approved foreign banks that local
commercial banks may correspond with and maintain their respective nostro accounts.\footnote{“Nostro account is defined as foreign exchange account maintained by a non-local (correspondent) bank with a local bank in local currency,” \textit{Oxford Dictionary of Trade and Banking}, Oxford University Press, Great Britain. via Google <http://www.businessdictionary.com/definition/nostro-account.html> viewed on 9 October, 2011.} Generally, banks are very careful when dealing with LCs originating from countries that face financial and political crises. Normally, LCs from such countries will not be accepted. In special circumstances where an LC from these countries are accepted or negotiated with, confirmation by the issuing bank is required. In such transactions, banks will request the IMB to check the validity of the bill of lading presented by the beneficiary. Another method adopted by banks to minimize fraud risk in LCs is the usage of Society for Worldwide Inter-bank Financial Telecommunication (SWIFT) to assist transactions. SWIFT are standard messages that are more expedient, simple, reliable and secured \cite{Lee}, used to facilitate international trade. Since only senior management of banks have the authority to authorize the sending of SWIFT messages issued by SWIFT standard messages, banks should be confident of the reliability and authenticity of LCs issued via SWIFT messages. On the other hand, banks should be more wary of those issued via fax, telex or airmail.

5. Conclusion

Evidently, LC transactions allow possible exploitation by fraudsters to fabricate and forge documents that may plausibly go undetected by unsuspecting bankers. Advancements in printing technology including state-of-the-art laser and colour printers have presented scrupulous parties immoral opportunities to fabricate documents that appear seemingly genuine. The highest fraud committed on documents is the bill of lading in international LCs and delivery order in local LCs. Since the existence of fraud must be proven with clear and solid evidence, banks are unable to cancel their payment undertaking under an LC transaction even when fraud is suspected.

In most fraudulent LC transactions, the party most seriously affected is usually the customer of the issuing bank, who in most cases is also the buyer in the transaction. They are at risk of having to service the credit facilities for goods that may not have been received or are of inferior quality. Hence, customers must be very careful with whom they are dealing with to avoid putting their business at risk. Nonetheless, sellers may also be at risk should a buyer present, to the port authorities upon collection of the goods, fabricated documents (for example, a bill of lading). In this case, the buyer would fabricate documents that have been used in previous dealings with other traders and bypass the due banking process and payment procedures. However, as far as banks are concerned, LC fraud cases leave little impact on financial institutions as these conglomerates will usually survive and move on. On the other hand, the impact on customers is more severe as they face possible bankruptcy.

The dilemma that banks face in dealing with fraudulent cases is perhaps not being able to intervene in such situations and being obligated to honour payment as long as the LC terms are complied with. Such predicament occurs because banks are bound by the UCP requirements of having to disburse payment even when the transaction is fallacious. There is unfortunately no provision dealing with LC fraud in all versions of the UCP. Hence, the matter is usually left to be dealt with by domestic law. However, in most cases, it has been argued that domestic law is neither comprehensive nor substantive enough to deal with commercial matters such as LC.
transactions that are extremely technical in nature. The standard of proof in fraud cases is very high and proving the existence of clear occurrence of fraud can be extremely challenging. There are times when courts are unable to serve appropriate punishment to fraudsters, ultimately releasing them without any sentence.

Over time, fraud cases relating to underlying contracts have grown not only in number but have evolved into becoming more sophisticated and complex given the rapid growth in technology. Thus, it is imperative that all parties play a role to mitigate the opportunity for fraudsters to commit their malicious intents. Fraud originating from the underlying contract has, to a certain degree, damaged the trust of financial institutions toward their customers to the extent that new, genuine applicants are being refused of credit approval in an introductory trade relationship.

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