Documentary Credits
An Introductory Guide

Introduction

The usual mode of transacting international business involves one or more of the following:

- **advance payment** (payment is effected before goods are shipped)
- **open account terms** (CAD – Cash Against Documents)
- **documentary collections** (CAD or D/A – Documents against Acceptance *of a draft*)
- **documentary credits** (stand-by credits are include under this heading)

What is a documentary credit (LC)

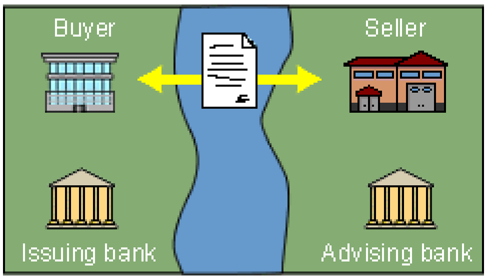
In simple language, an LC represents a more secure form of doing business than all but one (this being advance payment) of the other methods noted above. It is evidence of a four party agreement to pay against documents presented in conformity with the LC requirements. This agreement is supported by various separate contracts. These exist between applicant & issuing bank, between the banks themselves and the advising / confirming bank and the beneficiary. Thus the main parties involved are:

1. the LC applicant – this is the primary buyer of the goods
2. the LC beneficiary – this is the primary seller of the goods
3. the LC issuing bank – who gives effect to the buyer's instructions
4. the LC advising and/or confirming bank(s) – who transmit the LC to the seller

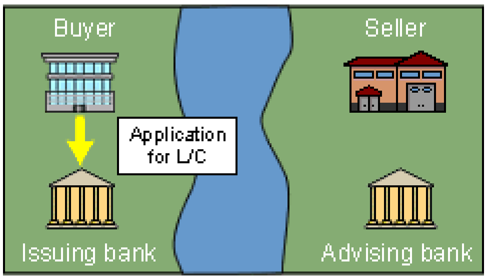
It is critical to remember that banks deal only with documents. They give no regard to the underlying transaction or goods. Provided the documents presented comply with the LC requirements, the paying bank must fulfil its independent payment undertaking. This means that the seller will be paid regardless of the buyer's ability or willingness to take up and pay for the documents. Exceptions to this general rule are referred to in a later section.

The Letter of Credit process

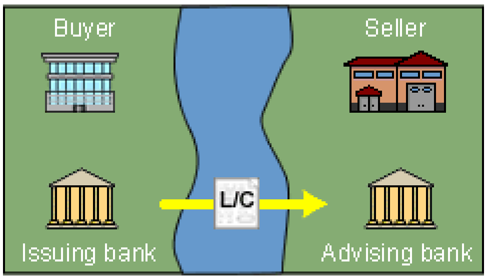
The process described below is for a sight letter of credit, with negotiation of documents by the Advising bank. Settlement procedures in letters of credit can be complex, and there are many variations on this.



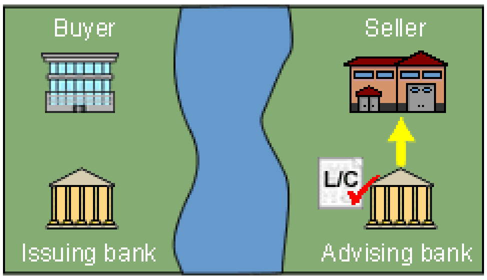
Buyer and seller agree terms, including means of transport, period of credit offered (if any), latest date of shipment, Incoterm (*) to be used.



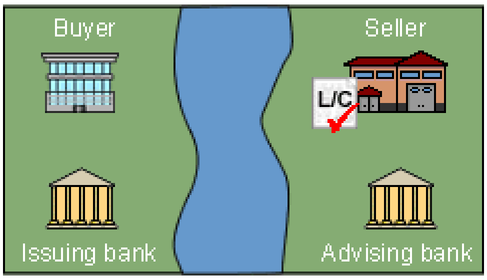
Buyer applies to bank for issue of letter of credit. Bank will evaluate buyer's credit standing, and may require cash cover and/or reduction of other lending limits.



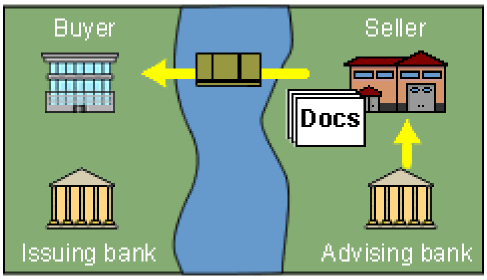
Issuing bank issues letter of credit, sending it to the Advising bank by airmail or (more commonly) electronic means such as SWIFT.



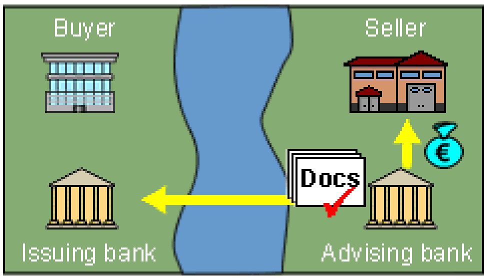
Advising bank establishes authenticity of the letter of credit using signature books or test codes, then informs seller (beneficiary). Advising bank MAY confirm letter of credit, i.e. add its own payment undertaking.



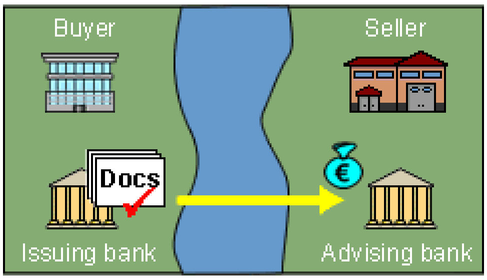
Seller should now check that letter of credit matches commercial agreement, and that all its terms and conditions can be satisfied, (e.g. all documents can be obtained in good time.) If there is anything that may cause a problem, an AMENDMENT must be requested.



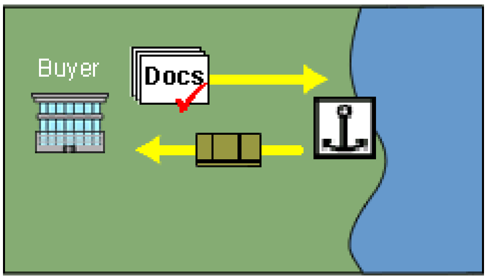
Seller ships the goods, then assembles the documents called for in the L/C (invoice, transport document etc.) Before presenting the documents to the bank, the seller should **check them for discrepancies** (**) with the letter of credit, and correct the documents where necessary.



The documents are presented to a bank, often the Advising bank. The Advising bank checks the documents against the L/C (**). If the documents are compliant, the bank pays the seller and forwards the documents to the Issuing bank.



The Issuing bank now checks the documents itself. If they are in order, then (for sight letters of credit) it reimburses the seller's bank immediately. For term letters of credit, settlement will be later.



The Issuing bank debits the buyer and releases the documents (including transport document), so that the buyer can claim the goods from the carrier.

Different Types of Letter of Credit

Irrevocable credit

Irrevocable credit means the credit cannot be amended or cancelled without the agreement of all parties (the beneficiary, the applicant and the issuing bank). A credit therefore should clearly indicate whether it is revocable or irrevocable. In the absence of such indication, the credit shall be deemed to be irrevocable.

Revocable credit

This type of credit may be amended or cancelled without the beneficiary's consent. Although rare, such LCs are sometimes seen because the cost of issuing them is lower due to their contingent (rather than unconditional) nature. It is generally used when the applicant and the beneficiary are members of the same group of companies or where a high degree of trust exists between the contracting parties.

Confirmed credit

The strength of a documentary credit is related to the financial standing of the bank that issues it. The economic strength of the country of the issuing bank is also a factor. In cases where the financial strength of the issuing country and/or bank is in doubt, the exporter may require another bank, preferably in the exporter's country, to provide its undertaking that the credit will be honoured. Consequently, the exporter is assured that drawings will be paid by the confirming bank in the event the issuing bank cannot do so, provided the terms and conditions of the credit are met. Remember, only the issuing bank may request another bank to add its confirmation. The common exception to this rule is that of a "silent confirmation" whereby the advising / confirming bank guarantees payment at the request of the beneficiary without any request by or knowledge of same by the issuing bank.

Transferable Credit

A transferable credit is a credit under which the beneficiary (first beneficiary) may request the transferring bank, or in the case of a freely negotiable credit, the bank specifically authorized in the credit as a transferring bank, to make the credit amount available in whole or in part to other beneficiary(ies). Only credits designated as transferable by the issuing bank can be transferred. Terms such as *divisible*, *fractionable*, *assignable* and *transmissible* do not render the credit transferable. If such terms are used, they will be disregarded.

Standby Letter of Credit

The standby letter of credit serves a different function than the commercial letter of credit. The commercial letter of credit is the primary payment mechanism for a transaction. The standby letter of credit serves as a secondary payment mechanism. A bank will issue a standby letter of credit on behalf of a customer to provide assurances of his ability to perform under the terms of a contract between the beneficiary. The parties involved with the transaction do not expect that the letter of credit will ever be drawn upon.

The standby letter of credit assures the beneficiary of the performance of the customer's obligation. The beneficiary is able to draw under the credit by presenting a draft, copies of invoices, with evidence that the customer has not performed its obligation. The bank is obligated to make payment if the documents presented comply with the terms of the letter of credit.

Standby letters of credit are issued by banks to stand behind monetary obligations, to ensure the refund of advance payment, to support performance and bid obligations, and to ensure the completion of a sales contract. The credit has an expiration date.

The standby letter of credit is often used to guarantee performance or to strengthen the credit worthiness of a customer. In the above example, the letter of credit is issued by the bank and held by the supplier. The customer is provided open account terms. If payments are made in accordance with the suppliers' terms, the letter of credit would not be drawn on. The seller pursues the customer for payment directly. If the customer is unable to pay, the seller presents a draft and copies of invoices to the bank for payment.

A standby letter of credit issued in the USA is governed by the Uniform Commercial Code. Under these provisions, the bank is given until the close of the third banking day after receipt of the documents to honor the draft.

Back-to-Back Letter of Credit

This is a new letter of credit opened based on an already existing, nontransferable credit used as collateral. Traders often use back-to-back arrangements to pay the ultimate supplier. A trader receives a letter of credit from the buyer and then opens another letter of credit in favor of the supplier. The first letter of credit serves as collateral for the second credit.

Deferred Payment (Usance) Letter of Credit

In Deferred Payment Letters of Credit, the buyer accepts the documents related to the letter of credit and agrees to pay the issuing bank after a fixed period. This credit gives the buyer a grace period for payment. The beneficiary can seek to transform this into a “sight” credit by obtaining an LC confirmation and then having the proceeds discounted. There are also cases (especially in Korea) of a deferred payment reimbursement but with the LC providing for sight payment to the beneficiary. Thus, the advising bank can pay the beneficiary at sight but will claim reimbursement for the documents face value plus interest at a later date.

Red Clause Letter of Credit

This name derives from historic LCs wherein the specific wording was shown in red to draw the banks' attention to the clause. Originally, such LCs were used to finance Australian wool producers. Red Clause Letters of Credit provide the seller with cash prior to shipment to finance production of the goods. The buyer's issuing bank may advance some or all of the funds. The buyer, in essence, extends financing to the seller and incurs the risk for all advanced credits. Quite often (especially with China) such LCs are linked to advance payment guarantees. These secure reimbursement of the advanced funds if documents, evidencing that goods have been shipped, are not presented within a certain time. Invoice values are paid on a pro rata basis so that the advanced funds, plus interest, are deducted on a running basis. Although rather complex, these LCs are a useful means of securing and documenting the funds advanced to the producer.

Revolving Letter of Credit

With a Revolving Letter of Credit, the issuing bank restores the credit to its original amount once it has been used or drawn down. Usually, these arrangements limit the number of times the buyer may draw down its line over a predetermined period. There are apparent advantages to these regarding limiting line utilisation, but invariably a bank will multiply the number of rolls and block the line with this value.

Transferable Letter of Credit (I)

This type of credit allows the seller to transfer all or part of the proceeds of the original letter of credit to one or more second beneficiaries, usually the ultimate supplier of the goods. It is most common for just one second beneficiary to be used. When several suppliers are involved the exercise becomes quite complex and ensuring provision of LC conform documents is itself a demanding exercise. The letter of credit must clearly state that it is transferable. This is a common financing tactic for middlemen and is common in East Asia.

Assignment of Proceeds (II)

This achieves the same object as the transferable credit but in a much simpler fashion. The beneficiary of a letter of credit may assign all or part of the proceeds under a credit to a third party (the assignee). However, unlike a transferred credit, the beneficiary maintains sole rights to the credit and is solely responsible for complying with its terms and conditions. For the assignee, an assignment only means that the paying bank, once it receives notice of the assignment, undertakes to follow the assignment instructions, if and when payment is made. The assignee is dependent upon the beneficiary for compliance, and thus this arrangement is riskier than a transferred credit. Before agreeing to an assignment of proceeds arrangement, the assignee should carefully review the original letter of credit.

Parties to a Letter of Credit

Beneficiary

The beneficiary is entitled to payment as long as he can provide the documentary evidence required by the letter of credit. The letter of credit is a distinct and separate transaction from the contract on which it is based. All parties deal in documents and not in goods. The issuing bank is not liable for performance of the underlying contract between the customer and beneficiary. The issuing bank's obligation to the buyer is to examine all documents to ensure that they meet all the terms and conditions of the credit. Upon requesting demand for payment the beneficiary warrants that all conditions of the agreement have been complied with. If the beneficiary (seller) is the party stipulated in the letter of credit, the seller must be paid by the bank.

Issuing Bank

The issuing bank's liability to pay and to be reimbursed from its customer becomes absolute upon the completion of the terms and conditions of the letter of credit. Under the provisions of the Uniform Customs and Practice for Documentary Credits (UDP 500), the bank is given a reasonable amount of time after receipt of the documents to honour the draft. Otherwise it must expressly reject the documents within 7 bank working days after receipt of same. The issuing bank's role is to provide a guarantee to the seller that if compliant documents are presented, the bank will pay the seller the amount due and to examine the documents, and only pay if these documents comply with the terms and conditions set out in the letter of credit. Typically the documents requested will include a commercial invoice, a transport document such as a bill of lading or airway bill and an insurance document; but there are many others. Parties to letters of credit deal strictly in documents, not the underlying goods.

Advising Bank

An advising bank, usually a foreign correspondent bank of the issuing bank, will advise the LC to the beneficiary. Generally, the beneficiary would want to use a local bank to ensure that the letter of credit is valid and binding. Hence LCs are transmitted by SWIFT or tested telex. In addition, the advising bank would be responsible for sending the documents to the issuing bank. The advising bank has no other obligation under the letter of credit. If the issuing bank does not pay the beneficiary, the advising bank is not obligated to pay.

Confirming Bank

The correspondent bank may confirm the letter of credit for the beneficiary. At the request of the issuing bank, the correspondent obligates itself to ensure payment under the letter of credit. The confirming bank would not confirm the credit until it evaluated the country and bank where the letter of credit originates. The confirming bank is usually the advising bank.

Checking a Standard LC Text

Field Comment(s)

21 Issuing bank's reference no. often required to be shown in some/all documents

31D Ensure the place of expiry accords with domicile of confirming bank and that the date of expiry permits sufficient time to present documents within LC validity (sometimes see "in beneficiary's country" which is wrong & needs amendment)

50 Applicant's address should be correctly written as this is the invoicing address and any serious misspelling(s) should be correspondingly amended

59 Beneficiary's address should be checked for any errors due to pre-determined invoice / other documents letter heading (potential problem re. consignor in BL)

32B Currency and amount must be that contractually agreed to ensure all goods can be shipped and claimed for under the LC

39A Tolerance to check vs contract if any agreed

39C Additional amounts covered refers to financing costs / usance interest etc. which is to be paid by the applicant and is added to the nominal invoice amount

41A The bank to which documents should be presented, this should ideally read "any bank by negotiation" as otherwise LC could be wrongly restricted to a bank other than that confirming the LC which will require subsequent amendment

42A The party upon whom drafts are to be drawn, preferably call for NO drafts!

42P If usance terms agreed e.g. 30/90/120/180 days etc. and to check vs contract

43P Are partial shipments needed to deliver full contract quantity, check vs contract

43T Even if transhipment is prohibited, this is allowed if container shipments made

44A Port(s) of loading contractually agreed, note the wording e.g. "Keelung and Taipei" means that goods must be shipped from <u>both</u> ports (and not possible if partial shipments are prohibited!) whereas "Keelung / Taipei" permits shipment from either one or the other port (ditto for "and/or" – "or" & similar phrases). BL <u>must</u> show only one port of loading, "any Taiwanese port" is forbidden

44B Port and/or inland destination agreed in contract, <u>Charter Party BLs</u> showing e.g. "any Taiwanese port" or "Keelung and/or Taipei" is allowed!

44C Ensure latest date of shipment can be complied with, otherwise have amended

44D Sometimes shows "X days after LC issuance" or similar, ensure compliance is possible or have LC amended

45A The description shown here <u>must</u> be given verbatim in the invoice, if partial shipment effected then re-state the quantity shipped elsewhere in the invoice. All other documents may show a more concise goods description that permits a link to be formed between all documents presented.

46A Enumerates the documents required and must be studied carefully to ensure that all documents called for can actually be presented. This applies especially to certain 3rd party documents: "Producer's / Mill's / Independent Surveyor's" certificates and the like. These usually take longer to obtain than one thinks and can contain typing / content errors which cannot easily be corrected and could cause discrepancies and thus prevent payment and/or acceptance of all documents presented.

- An LC calling for e.g. "Lloyds Maritime Registration certificate or similar" re. the vessel's age demands a document of equal value, a shipping co. certificate will not suffice unless confirming bank agrees to accept such (preferably a priori).

- Does the LC permit / prohibit a Charter Party BL, make sure how goods are going to be shipped to prevent an automatic, external reserve!

- If the LC calls for an Insurance Policy have this amended, do not use our standard forms and change "Certificate" to "Policy" as these documents are fundamentally different. Will inevitably attract a (usually external) reserve.

Other problems relating to documents required are deals with in greater detail in the Advanced Course to follow.

47A Additional Conditions <u>must</u> be read carefully upon receipt of LC as they often require presentation of further documents e.g. fax shipment advice, N.O.R. etc. and sometimes contain "Stop Clauses" preventing independent utilisation of LC

71B Charges are normally split equitably between applicant and beneficiary but if the issuing bank's charges are shown to be for our account beware, this can be very expensive! Have amended if not contractually agreed to.

48 The no. of days after shipment within which documents have to be presented, so make sure one has sufficient time to collate and present all necessary docs.

49 Confirmation instructions must show "to add" or "may add" etc. if a confirmed LC has been agreed upon.

Some Common Issues which can Destroy the Value of a Letter of Credit

- Letter of Credit has expired prior to presentation of draft.
- Letter of Credit is over or underdrawn e.g. invoice error or partial shipment made
- Bill of Lading evidences delivery prior to or after the date range stated in the credit.
- Bill of Lading is claused re. quality of goods and/or packing, unverified alterations.
- Stale dated documents e.g. presented later than 21 days after issuane.
- Changes included in the invoice not authorized in the credit.
- Documents evidence inconsistent description of goods between themselves.
- Insurance document errors e.g. over/under insuring the goods, date not as per BL.
- Invoice amount not equal to draft amount.
- Ports of loading and destination not as specified in the credit.
- Description of merchandise is not as stated in credit.
- A document required by the credit is not presented.
- Documents are inconsistent as to general information such as volume, quality, etc.
- Names of documents not exactly as described in the credit.
- Combined documents e.g. one Weight **and** Quality certificate presented instead of two separate documents (the LC wording is important in this respect)
- Beneficiary information must be exact.
- Invoice or statement is not signed as stipulated in the letter of credit.
- The Reimbursement Authorisation is withdrawn or expires.

Supporting the Parties to an LC in Setting Up the Framework

Seller

1. Before signing a sales contract, the seller should make inquiries about the buyer's creditworthiness and business practices. The seller's bank will generally assist in this investigation.

2. In many cases, the issuing bank will specify the advising and/or confirming bank. These designations are usually based on the issuing bank's established correspondent relationships. The seller should ensure that the advising/confirming bank is a financially sound institution.

3. The seller should confirm the good standing of the buyer's issuing bank if the letter of credit is unconfirmed.

4. For confirmed letters of credit, the seller's advising bank should be willing to confirm the letter of credit issued by the buyer's bank. If the advising bank refuses to do so, the seller should request another issuing bank as the current bank may be or is in the process of becoming insolvent.

5. The seller should carefully review the letter of credit to ensure its conditions can be met. All documents must conform to the terms of the letter of credit. The seller must comply with every detail of the letter of credit specifications; otherwise the security given by the credit is lost.

6. The seller should ensure that the letter of credit is irrevocable.

7. If amendments are necessary, the seller should contact the buyer immediately so that the buyer can instruct the issuing bank to make the necessary changes quickly. The seller should keep the letter of credit's expiration date in mind throughout the amendment process.

8. The seller should confirm with the insurance company that it can provide the coverage specified in the letter of credit and that insurance charges listed in the letter of credit are correct. Typical insurance coverage is for CIF (cost, insurance and freight) often the value of the goods plus about 10 percent.

9. The seller must ensure that the goods match the description in the letter of credit and the invoice description.

10. The seller should be familiar with foreign exchange limitations in the buyer's country that could hinder payment procedures.

Buyer

1. When choosing the type of letter of credit, the buyer should consider the standard payment methods in the seller's country.

2. The buyer should keep the details of the purchase short and concise.

3. The buyer should be prepared to amend or re-negotiate terms of the letter of credit with the seller. This is a common procedure in international trade. With irrevocable letters of credit, the most common type, all parties must agree to amend the document.

4. The buyer can reduce the foreign exchange risk by buying forward currency contracts.

5. The buyer should use a bank experienced in foreign trade as its issuing bank.

6. The validation time stated on the letter of credit should give the seller ample time to produce the goods or to pull them out of stock.

7. A letter of credit is not fail-safe. Banks are only responsible for the documents exchanged and not the goods shipped. Documents in conformity with the letter of credit specifications cannot be rejected on grounds that the goods were not delivered as specified in the contract. The goods shipped may not in fact be the goods ordered and paid for.

8. Purchase contracts and other agreements pertaining to the sale between the buyer and seller are not the concern of the issuing bank. Only the letter of credit terms are binding on the bank.

9. Documents specified in the letter of credit should include those the buyer requires for customs clearance.

Tips for Exporters

- Communicate with your customers in detail before they apply for letters of credit.
- Consider whether a confirmed letter of credit is needed.
- Ask for a copy of the application to be fax to you, so you can check for terms or conditions that may cause you problems in compliance.
- Upon first advice of the letter of credit, check that all its terms and conditions can be complied with within the prescribed time limits.
- Many presentations of documents run into problems with time-limits. You must be aware of at least three time constraints - the expiration date of the credit, the latest shipping date and the maximum time allowed between dispatch and presentation.
- If the letter of credit calls for documents supplied by third parties, make reasonable allowance for the time this may take to complete.

After dispatch of the goods, check all the documents both against the terms of the credit and against each other for internal consistency.

Some Examples of LC Issues and Problems

Sovereign Risk

This should not be underestimated. In 1989 Brazil introduced a new currency and limited foreign currency remittances to $ 1'200.- per year for non-recognised payments. Using LCs eliminated this particular risk.

Venezuala nationalised various companies at one time thus freezing the assets of foreign companies. An American oil company shipped sundry broken and rusty tools, called it "oil drilling equipment" and presented LC conform documents. By this means, and using a confirmed LC, they could reduce their losses of $30 mio. (frozen assests) by $ 7 mio.

In the 1970's Nigeria erroneously ordered 22 mio. tons of cement, this was 5 times more than was required. The government instructed Nigerian banks who had issued LCs for cement not to pay against them. They complied and several foreign suppliers and banks suffered heavy losses.

Several countries still use LCs to control and monitor foreign the flow of external payments, India and China amongst them.

Incoterms and Transport Documents

If the sales contract stipulates Ex Works or FOB, ensure the LC does not call for an ocean bill of lading! If the client is unsure which delivery term is best advise them to refer to Incoterms 2000 which lists and defines all the commercially common delivery modes.

Given the choice, always opt upon a negotiable bill of lading (issued to order & blank endorsed) as this gives greatest flexibility and control over the goods. A "straight" bill of lading is consigned to the receiver and only he can take over and dispose of the goods. If at all possible, in export deals avoid bills of lading issued to order of another bank, they may decline to endorse it and thus incur delays and considerable expense, especially in demurrage and subsequent storage.

If your client sells Ex Works he loses control over and title to the goods as soon as they are loaded

Banks will compare, not interpret, the goods description and other terms

A buyer ordered Scotch Whiskey. The LC goods description stipulated this term. The seller's invoice showed "Scotch-type Whiskey." The bank called the applicant, the applicant called the beneficiary but he declined to change the invoice. Documents were rejected and goods returned. Who knows what was actually shipped?!

In another case, the LC called for No. 2 Yellow Corn or Better. The sales invoice showed "No. 1 Yellow Corn." The bank rejected the documents. Banks cannot be expected to know that No. 1 Yellow Corn is indeed better than No. 2. Always ensure the goods description is unambiguous!

Getting Paid for the Documents

Bearing in mind that between 50 – 80% of all document sets are discrepant, the chances of having documents rejected is considerable. This is an important consideration in any LC but especially when dealing with back-to-back and transferable LCs.

In a falling market a buyer may instruct to find his bank to find a discrepancy at any price. This happens more often than one would like to think! From personal experience I have seen multi million dollar deals turn into significant loss makers due to incompetent document preparation and failure to comply with basic LC requirements. The managers were not pleased and revenge was taken at the annual bonus allocation ……..

Talking of revenge and discrepant documents, a company importing cue sticks (for billiards) had as a supplier a company that always presented discrepant documents. The applicant invariably contacted the seller to negotiate a discount before accepting the documents. Finally, the seller presented exactly LC conform documents and the bank paid without contacting the applicant. When the buyer inspected the cartons, they contained not cue sticks but freshly cut branches! This illustrates two points: banks deal in documents and companies often deal with rogues …..

Make sure documents are sent to the right bank. You think this is obvious? Asian LCs often require original documents to be sent to a designated branch whereas the reimbursement claim is to be handled by a 3rd party bank. Payment will be made without the issuing bank ever seeing the original documents. I have seen instances of avoidable delays due to mis-routing of documents and large demurrage claims due to vessels arriving before the documents. This usually happens when the client tells the bank that the transit time is short and handling speed is of the essence …