

Guide to Letters of Credit

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Introduction to Documentary Letters of Credit



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Letters of Credit Defined

A documentary credit is the written promise of a bank, undertaken on behalf of a buyer, to pay a seller the amount specified in the credit provided the seller complies with the terms and conditions set forth in the credit. The terms and conditions of a documentary credit revolve around two issues: (1) the presentation of documents that evidence title to goods shipped by the seller, and (2) payment.

In simple terms, banks act as intermediaries to collect payment from the buyer in exchange for the transfer of documents that enable the holder to take possession of the goods.

Documentary credits provide a high level of protection and security to both buyers and sellers engaged in international trade. The seller is assured that payment will be made by a party independent of the buyer so long as the terms and conditions of the credit are met. The buyer is assured that payment will be released to the seller only after the bank has received the title documents called for in the credit.

Documentary credits are so named because of the importance of documents in the transaction. Letter of credit (L/C) is the historic and popular term used for a documentary credit because such credits were and are transmitted in the form of a letter from the buyer's bank. Both "documentary credit" and "letter of credit" will be used for our discussions.

Types of Credits

There are a number of different types of standard and special documentary credits. Each type contains a variety of features designed to meet the different needs of buyers, sellers, or the banks involved. For example, standard documentary credits can be either revocable (may be cancelled by the buyer), or irrevocable (noncancellable by the buyer), or confirmed (a second bank, in addition to the buyer's bank, guarantees payment) or unconfirmed (payment guaranteed only by the issuing bank). The most popular variation for sellers is the irrevocable confirmed credit because it cannot be cancelled by the buyer, and a second bank (usually the seller's bank) adds its guarantee of payment to that of the buyer's bank. Standard credits are discussed later in this section.

Specialized credits include revolving credits, red clause credits, standby credits, transferable credits, and back-to-back credits. These are also discussed later this section. This section is designed as an introduction to letters of credit. It is not comprehensive. To learn more about letters of credit and other types of international payments see *A Short Course in International Payments*, also available from World Trade Press.

Limitations of Letters of Credit

Although documentary credits provide good protection and are the preferred means of payment in many international transactions, they do have limitations. They do not, for example, ensure that the goods actually shipped are as ordered nor do they insulate buyers

and sellers from other disagreements or complaints arising from their relationship. It is up to the parties to settle questions of this nature between themselves.

Advantages, disadvantages, and issues for both buyer and seller will be discussed later in this section. Please note that these issues can have a significant impact on a given transaction. An incomplete understanding of the subject can be more dangerous than no knowledge at all.

Role of Banks

It is important to note, and not for the last time, that a fundamental principle of documentary credits is that banks deal in documents and not goods. Banks are responsible for issues relating to documents and the specific wording of the documentary credit as opposed to issues relating to the goods themselves.

Therefore, banks are not concerned if a shipment is in conformity with the documents, only that the documents are in conformity to the wording of the credit.

The Uniform Customs and Practice

Although documentary credits, in one form or another, have been in use for a long time, questions arose about how to effect transactions in a practical, fair, and uniform manner.

The Uniform Customs and Practice for Documentary Credits (UCP) is the internationally recognized codification of rules unifying banking practice regarding documentary credits. The UCP was developed by a working committee attached to the International Chamber of Commerce (ICC) in Paris. It is revised and updated from time to time; the current valid version is ICC publication No. 500. See the [Resources Appendix](#) for contact information for the ICC.

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