Training, support & information on letters of credit & trade finance

As many exporters know, mistakes with letters of credit can be the cause of expense, delay and frustration. This quick guide presents the basics; however if you use letters of credit for a significant proportion of your business, we strongly recommend comprehensive training.

What is a letter of credit?

A letter of credit is a banking mechanism which allows importers to offer secure terms to exporters

All letters of credit contain these elements:

- a payment undertaking given by a bank (Issuing bank) on behalf of a buyer (applicant)
- to pay a seller (beneficiary) a given amount of money.
- on presentation of specified documents representing the supply of goods
- within specified time limits
- these documents conforming to the terms and conditions set out in the letter of credit
- the documents to be presented at a specified place

Put simply, the Issuing bank has two main roles:

- To give a binding undertaking to the seller that if compliant documents are presented, the bank will pay the seller the amount due. This offers security to the seller - the bank says in effect "We will pay you if you present these documents (XYZ)"
- To examine the documents, and only pay if these comply with the terms and conditions set out in the letter of credit. This protects the buyer's interests - the bank says "We will only pay your supplier on your behalf if they present the documents (XYZ) that you have asked for"

Note that the letter of credit refers to documents representing the goods, not the goods themselves! Banks are not in the business of examining goods on behalf of their customers.

Letters of credit will typically call for a commercial invoice, a transport document such as a bill of lading or airway bill, and an insurance document, but there are many others that may be required..

Letters of credit deal in documents, not goods.

Learn more! [Trade Tutor *online*]

Mantissa's training products on letters of credit are now in routine use in the training departments of hundreds of banks and trading organisations around the world.

More effective than a conventional classroom-based training course, computer based training allows students to progress at their own pace and provides the training manager with vital information on the progress and attainment of each learner.

When are letters of credit used?

Letters of credit are used for the following reasons:

- To protect against **buyer risk.**

  Where buyers are of unknown creditworthiness, letters of credit provide the seller with the security of a bank's payment undertaking.

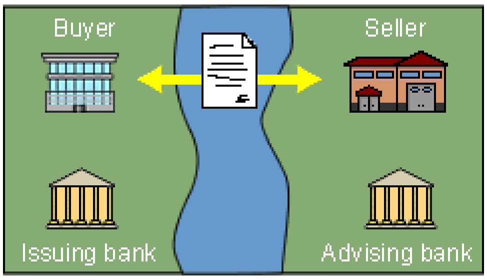
- To protect against **country risk.**

  The buyer may be willing and able to pay; but economic or political conditions in the buyer's country may prevent or delay payment. This is a real concern when dealing with less developed countries and/or countries with periodic foreign exchange shortages. To protect against these risks, a confirmed letter of credit will be necessary - a bank in the seller's country will (for a fee) add its own payment undertaking to that of the Issuing bank.

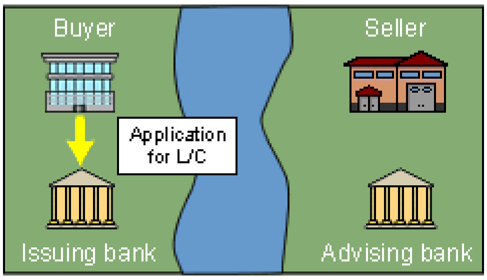
- Letters of credit are also used as part of **exchange control** or **import control** regimes operating in the buyer's country. In such cases the use of a letter of credit is mandatory, even if not required by the seller for security reasons.

The letter of credit process

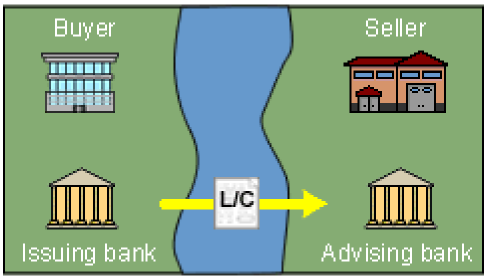
The process described below is for a sight letter of credit, with negotiation of documents by the Advising bank. Settlement procedures in letters of credit can be complex, and there are many variations on this.



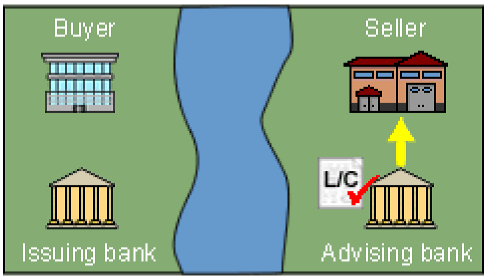
Buyer and seller agree terms, including means of transport, period of credit offered (if any), latest date of shipment, Incoterm (*) to be used.



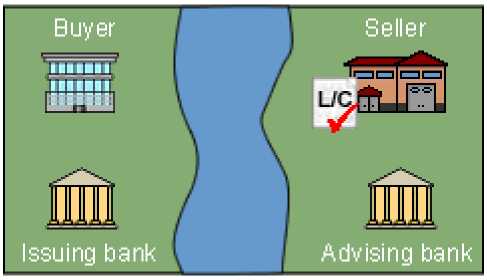
Buyer applies to bank for issue of letter of credit. Bank will evaluate buyer's credit standing, and may require cash cover and/or reduction of other lending limits.



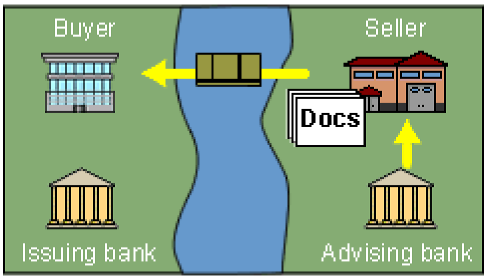
Issuing bank issues letter of credit, sending it to the Advising bank by airmail or (more commonly) electronic means such as SWIFT.



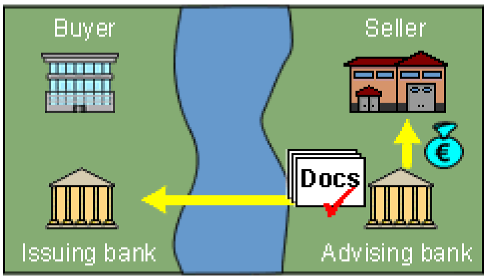
Advising bank establishes authenticity of the letter of credit using signature books or test codes, then informs seller (beneficiary). Advising bank MAY confirm letter of credit, i.e. add its own payment undertaking.



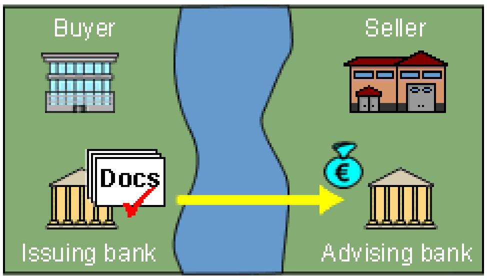
Seller should now check that letter of credit matches commercial agreement, and that all its terms and conditions can be satisfied, (e.g. all documents can be obtained in good time.) If there is anything that may cause a problem, an AMENDMENT must be requested.



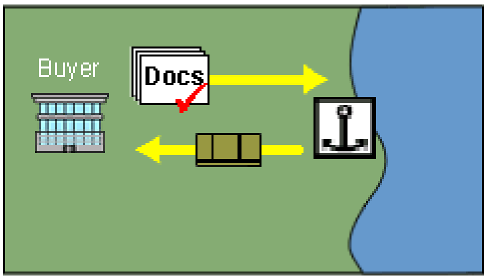
Seller ships the goods, then assembles the documents called for in the L/C (invoice, transport document etc.) Before presenting the documents to the bank, the seller should **check them for discrepancies** (**) with the letter of credit, and correct the documents where necessary.



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.

[Glossary](#) [Mantissa training products](#)

NOTES

(*) Letters of credit and **Incoterms**. Some Incoterms are better suited to use with letters of credit than others. Specifically, the C terms (CIF, CFR, CIP, CPT) work well, but others may cause problems.
See our Incoterms course for more.

(**) Determination whether documents **comply** with the terms and conditions of letters of credit. The key document is the International Chamber of Commerce Uniform Customs and Practice for Documentary Credits, more commonly known as UCP 500 All exporters who work with letters of credit need a good understanding of this.

Another important ICC publication is ISBP 645 - International Standard Practice for the Examination Documents under Documentary Credits.

There is also **eUCP**, which covers electronic presentations. The issue of letters of credit by electronic means has been standard practice for many years (SWIFT MT700 messages.) However the technical means now exist for the electronic presentation of the documents called for by letters of credit.

The problem for exporters

Statistics show that in as many as 50% of transactions using letters of credit, the seller's documents will be rejected by the banks at presentation. This can be an extreme source of frustration to both the importer and the exporter.

At the heart of the problem is the very limited discretion available to banks in the matching of the terms and conditions of the credit against the documents presented. They must do this in a very literal way, with no room for the exercise of judgement.

For example, suppose that a letter of credit calls for goods described as "Potassium chlorate crystals, minimum purity 98%". However the exporter presents a commercial invoice referring to the goods as "Potassium chlorate crystals, 99.5% purity".

Common sense would suggest that this consignment will be acceptable to the buyer! However some banks do not feel able to make this assumption, and will reject the documents on the grounds of a discrepancy in the goods description.

There are numerous cases of apparently trivial variations between the terms of the credit and the documents (or between one document and another document) causing documents to be rejected. Hence exporters must learn to check documents before submission, using the same criteria that will be applied by the banks themselves.

Another source of problems is the failure of the letter of credit to anticipate some aspect of the transaction.

For example a common requirement on a credit is for presentation of a 'clean on-board bill of lading' - a document supplied by the shipping company attesting that the goods were received in apparently good condition, and were loaded in the ship's hold. However if the goods are hazardous or flammable, they will be put on the deck of the ship instead of the hold, and the bill of lading will be marked 'on deck'. This is not an on-board bill of lading, so the documents must be rejected by the bank.

Tips for exporters

For trouble-free letter of credit transactions:

- Communicate with your customers in detail before they apply for letters of credit. The letter of credit is part of the sales process, not the shipping process!
- Consider whether a **confirmed** letter of credit is needed **-** if in doubt, seek advice.
- Ask for a **copy of the application** to be faxed 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 up to three time constraints - the expiry date of the credit, the latest shipping date and the presentation period - maximum time allowed between despatch and presentation of documents.
- If the letter of credit calls for documents supplied by third parties, make reasonable allowance for the time this may take to organise
- **After despatch of the goods**, check all the documents both against the terms of the credit and against each other for internal consistency.

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