

Chapter 3

Letters of Credit

Letters of credit (LCs) are one of the most secure instruments available to international traders. An LC is a commitment by a bank on behalf of the buyer that payment will be made to the beneficiary (exporter) provided that the terms and conditions stated in the LC have been met, consisting of the presentation of specified documents. The buyer pays his bank to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but the exporter is satisfied with the creditworthiness of the buyer's foreign bank. This method also protects the buyer since the documents required to trigger payment provide evidence that the goods have been shipped or delivered as promised. However, because LCs have many opportunities for discrepancies, documents should be prepared by well-trained professionals or outsourced. Discrepant documents, literally not having an “*i dotted and t crossed*,” can negate the bank's payment obligation.

Key Points

- An LC, also referred to as a documentary credit, is a contractual agreement whereby the issuing bank (importer's bank), acting on behalf of its customer (the buyer or importer), authorizes the nominated bank (exporter's bank), to make payment to the beneficiary or exporter against the receipt of stipulated documents.
- The LC is a separate contract from the sales contract on which it is based; therefore, the bank is not concerned whether each party fulfills the terms of the sales contract.
- The bank's obligation to pay is solely conditioned upon the seller's compliance with the terms and conditions of the LC. In LC transactions, banks deal in documents only, not goods.
- LCs can be arranged easily for one-time deals.
- Unless the conditions of the LC state otherwise, it is always irrevocable, which means the document may not be changed or cancelled unless the seller agrees.

Confirmed Letter of Credit

A greater degree of protection is afforded to the exporter when an LC issued by a foreign bank (the importer's issuing bank) is confirmed by a U.S. bank and the exporter asks its customer to have the issuing bank authorize a bank in the exporter's country to confirm (the advising bank, which then becomes the confirming bank). This confirmation means that the U.S. bank adds its engagement to pay the exporter to that of the foreign bank. If an LC is not confirmed, the exporter is subject to the payment risk of the foreign bank and the

CHARACTERISTICS OF A LETTER OF CREDIT

Applicability

Recommended for use in new or less-established trade relationships when the exporter is satisfied with the creditworthiness of the buyer's bank.

Risk

Risk is evenly spread between seller and buyer, provided that all terms and conditions are adhered to.

Pros

- Payment made after shipment
- A variety of payment, financing, and risk mitigation options available

Cons

- Complex and labor-intensive process
- Relatively expensive method in terms of transaction costs

political risk of the importing country. Exporters should consider getting confirmed LCs if they are concerned about the credit standing of the foreign bank or when they are operating in a high-risk market, where political upheaval, economic collapse, devaluation or exchange controls could put the payment at risk.

Illustrative Letter of Credit Transaction

1. The importer arranges for the issuing bank to open an LC in favor of the exporter.
2. The issuing bank transmits the LC to the nominated bank, which forwards it to the exporter.
3. The exporter forwards the goods and documents to a freight forwarder.
4. The freight forwarder dispatches the goods and submits documents to the nominated bank.
5. The nominated bank checks documents for compliance with the LC and collects payment from the issuing bank for the exporter.
6. The importer's account at the issuing bank is debited.
7. The issuing bank releases documents to the importer to claim the goods from the carrier and to clear them at customs.

Special Letters of Credit

LCs can take many forms. When an LC is made transferable, the payment obligation under the original LC can be transferred to one or more "second beneficiaries." With a revolving LC, the issuing bank restores the credit to its original amount each time it is drawn down. A standby LC is not intended to serve as the means of payment for goods but can be drawn in the event of a contractual default, including the failure of an importer to pay invoices when due. Standby LCs are often posted by exporters in favor of importers as well because they can serve as bid bonds, performance bonds, and advance payment guarantees. In addition, standby LCs are often used as counter guarantees against the provision of down payments and progress payments on the part of foreign buyers. A buyer may object to a seller's request for a standby LC for two reasons: it ties up a portion of the seller's line of credit and it is costly.

Tips for Exporters

- Consult with your bank before the importer applies for an LC.
- Consider whether a confirmed LC is needed.
- Negotiate with the importer and agree on detailed terms to be incorporated into the LC.
- Determine if all LC terms can be met within the prescribed time limits.
- Ensure that all the documents are consistent with the terms and conditions of the LC.
- Beware of many discrepancy opportunities that may cause non-payment or delayed payment.