Understanding and Using Letters of Credit, Part II

Castle Consultants thanks Jacob Hames / Gunther Hartmann for their contribution in this section

Purpose

The purpose of this document is to provide a general understanding of letters of credit, their use and application. The topics covered are the following:

- General background information;
- Types of letters of credit;
- Common problems with letters of credit;
- Procedures for establishing letters of credit;
- Amendments; and
- General tips to both buyers and sellers.

In addition, attachments to this document detail a step-by-step letter of credit procedures.

Definition

Letters of credit are commonly used to reduce credit risk to sellers in both domestic and international sales arrangements. By having a bank issue a letter of credit, in essence, one is substituting the bank's credit worthiness for that of the customer.

Types

There are two basic forms of letters of credit: Standby and Documentary. Documentary letters of credit can be either Revocable or Irrevocable, although the first is extremely rare. Irrevocable letters of credit can be Confirmed or Not Confirmed. Each type of credit has advantages and disadvantages for the buyer and for the seller, which this information will review below. Charges for each type will also vary. However, the more the banks assume risk by guaranteeing payment, the more they will charge for providing the service.

Documentary Revocable Letter of Credit

Revocable credits may be modified or even canceled by the buyer without notice to the seller. Therefore, they are generally unacceptable to the seller.

Documentary Irrevocable Letter of Credit

This is the most common form of credit used in international trade. Irrevocable credits may not be modified or canceled by the buyer. The buyer's issuing bank must follow through with payment to the seller so long as the seller complies with the conditions listed in the letter of credit. Changes in the credit must be approved by both the buyer and the seller. If the documentary letter of credit does not mention whether it is revocable or irrevocable, it automatically defaults to irrevocable. See Credit Administration, Sample Procedure for Administration of a Documentary Irrevocable Letters of Credit for a systematic procedure for establishing an irrevocable letter of credit.

There are two forms of irrevocable credits:

Unconfirmed credit (the irrevocable credit not confirmed by the advising bank)
In an unconfirmed credit, the buyer's bank issuing the credit is the only party responsible for payment to the seller. The seller's advising bank pays only after receiving payment from the issuing bank. The seller's advising bank merely acts on behalf of the issuing bank and, therefore, incurs no risk.

Confirmed credit (the irrevocable confirmed credit) In a confirmed credit, the advising bank adds its guarantee to pay the seller to that of the buyer's issuing bank. Once the advising bank reviews and confirms that all documentary requirements are met, it will pay the seller. The advising bank will then look to the issuing bank for payment. Confirmed Irrevocable letters of credit are used when trading in a high-risk area where war or social, political, or financial instability are real threats. Also common when the seller is unfamiliar with the bank issuing the letter of credit or when the seller needs to use the confirmed letter of credit to obtain financing its bank to fill the order. A confirmed credit is more expensive because the bank has added liability.

Standby Letter of Credit

This credit is a payment or performance guarantee used primarily in the United States. They are often called non-performing letters of credit because they are only used as a backup should the buyer fail to pay as agreed. Thus, a stand-by letter of credit allows the customer to establish a rapport with the seller by showing that it can fulfill its payment commitments. Standby letters of credit are used, for example, to guarantee repayment of loans, to ensure fulfillment of a contract, and to secure payment for goods delivered by third parties. The beneficiary to a standby letter of credit can cash it on demand. Stand-by letters of credit are generally less complicated and involve far less documentation requirements than irrevocable letters of credit. See Credit Administration, Sample Procedure for Administration of a Standby Letter of Credit for a systematic procedure for establishing a standby letter of credit.

Special Letters of Credit The following is a brief description of some special letters of credit.

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.

Red Clause Letter of Credit

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.

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.

Transferable Letter of Credit

This type of credit allows the seller to transfer all or part of the proceeds of the original letter of credit to a second beneficiary, usually the ultimate supplier of the goods. The letter of credit must clearly state that it is transferable for its to be considered as such. This is a common financing tactic for middlemen and is common in East Asia.

Assignment of Proceeds

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.

Common Problems with Letters of Credit

Most problems result from the seller's inability to fulfill obligations stated in the letter of credit. The seller may find these terms difficult or impossible to fulfill and, either tries to fulfill them and fails, or asks the buyer to amend to the letter of credit. As most letters of credit are irrevocable, amendments may at times be difficult since both the buyer and the seller must agree.

Sellers may have one or more of the following problems:

- The shipment schedule cannot be met;
- The stipulations concerning freight costs are unacceptable;
- The price becomes too low due to exchange rates fluctuations;
- The quantity of product ordered is not the expected amount;
- The description of product is either insufficient or too detailed; and,
- The stipulated documents are difficult or impossible to obtain.

Even when sellers accept the terms of a letter of credit, problems often arise late in the process. When this occurs, the buyer's and seller's banks will try to negotiate any differences. In some cases, the seller can correct the documents and present them within the time specified in the letter of credit. If the documents cannot be corrected, the advising bank will ask the issuing bank to accept the documents despite the discrepancies found. It is important to note that, if the documents are not in accord with the specifications of the letter of credit, the buyer's issuing bank is no longer obligated to pay.

Basic Procedures for Establishing a Letter of Credit

The letter of credit process has been standardized by a set of rules published by the International Chamber of Commerce (ICC). These rules are called the Uniform Customs and Practice for Documentary Credits (UCP) and are contained in ICC Publication No. 500. The following is the basic set of steps used in a letter of credit transaction. Specific letter of credit transactions follow somewhat different procedures.

1. After the buyer and seller agree on the terms of a sale, the buyer arranges for his bank to open a letter of credit in favor of the seller. Note: The buyer will need to have a line of credit established at the bank or provide cash collateral for the amount of the letter of credit.

2. The buyer's issuing bank prepares the letter of credit, including all of the buyer's instructions to the seller concerning shipment and required documentation.

3. The buyer's bank sends the letter of credit to the seller's advising bank.

4. The seller's advising bank forwards the letter of credit to the seller.

5. The seller carefully reviews all conditions stipulated in the letter of credit. If the seller cannot comply with any of the provisions, it will ask the buyer to amend the letter of credit.

6. After final terms are agreed upon, the seller ships the goods to the appropriate port or location.

7. After shipping the goods, the seller obtains the required documents. Please note that the seller may have to obtain some documents prior to shipment.

8. The seller presents the documents to its advising bank along with a draft for payment.

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9. The seller's advising bank reviews the documents. If they are in order, it will forward them to the buyer's issuing bank. If a confirmed letter of credit, the advising bank will pay the seller (cash or a bankers' acceptance).

10. Once the buyer's issuing bank receives and reviews the documents, it either (1) pays if there are no discrepancies; or (2) forwards the documents to the buyer if there are discrepancies for its review and approval.

Opening a Letter of Credit Level of Detail

The wording in a letter of credit should be simple, but specific. The more detailed an L/C is, the more likely the seller will reject it as too difficult to fulfill. At the same time, the buyer will wish to define in detail what its is paying for.

Type of Credit

Letters of credit used in trade are usually either irrevocable unconfirmed credits or irrevocable confirmed credits. In choosing which type to open both the seller and the buyer should consider the generally accepted payment processes in each country, the value and demand for the goods, and the reputation of the buyer and seller.

Documents

In specifying required documents, it is very important to include those required for customs and those reflecting the agreement reached between the buyer and the seller. Required documents usually include the bill of lading, a commercial and/or consular invoice, the bill of exchange, the certificate of origin, and the insurance document. Other documents required may be an inspection certificate, copies of a cable sent to the buyer with shipping information, a confirmation from the shipping company of the state of its ship, and a confirmation from the forwarder that the goods are accompanied by a certificate of origin. Prices should be stated in the currency of the letter of credit and documents should in the same language as the letter of credit.

The Letter of Credit Application

The following information should be addressed when establishing a letter of credit.

1. Beneficiary The seller should provide to the buyer its full corporate name and correct address. A simple mistake here may translate to inconsistent or improper documentation at the other end.

2. Amount The seller should state the actual amount of the letter of credit. One can request a maximum amount when there is doubt as to the actual count or quantity of the goods. Another option is to use words like "approximate", "circa", or "about" to indicate an acceptable 10 % plus or minus from the stated amount. For consistency, if you use this wording you will need to use it also in connection with the quantity.

3. Validity The seller will need time to ship and to prepare all the necessary documents. Therefore, the seller should ensure that the validity and period for document presentation after the shipment of the goods is long enough.

4. Seller's Bank The seller should list its advising bank as well as a reimbursing bank if applicable. The reimbursing bank is the local bank appointed by the issuing bank as the disbursing bank.

5. Type of Payment Availability The buyer and seller may agree to use sight drafts, time drafts, or some sort of deferred payment mechanism.

6. Desired Documents The buyer specifies the necessary documents. Buyers can list, for example, a bill of lading, a commercial invoice, a certificate of origin, certificates of analysis, etc. The seller must agree to all documentary requirements or suggest an amendment to the letter of credit.

7. Notify Address This is the address to notify upon the imminent arrival of goods at the port or airport of destination. A notification listing damaged goods is also sent to this address, if applicable.

8. Description of Goods The seller should provide a short and precise description of the goods as well as the quantity involved. Note the comments in step #2 above concerning approximate amounts.

9. Confirmation Order With international arrangements, the seller may wish to confirm the letter of credit with a bank in its country.

Amendment of a Letter of Credit

For the seller to change the terms noted on an irrevocable letter of credit, it must request an amendment from the buyer. The amendment process is as follows:

1. The seller requests a modification or amendment of questionable terms in the letter of credit;
2. If the buyer and issuing bank agree to the changes, the issuing bank will change the letter of credit;
3. The buyer's issuing bank notifies the seller's advising bank of the amendment; and
4. The seller's advising bank notifies the seller of the amendment. Tips for Buyers and Sellers

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.