

Chapter 3

Letters of Credit

Letters of credit (LCs) are among 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 have been met, as verified through the presentation of all required documents. The buyer pays its bank to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but you are satisfied with the creditworthiness of your buyer's foreign bank. This method also protects the buyer, since no payment obligation arises until the documents proving that the goods have been shipped or delivered as promised are presented. However, since LCs have many opportunities for discrepancies, they should be prepared by well-trained documenters or the function may need to be outsourced. Discrepant documents, literally not having an "I-dotted and T-crossed," can negate payment.

Key Points

- An LC, also referred to as a documentary credit, is a contractual agreement whereby a bank in the buyer's country, known as the issuing bank, acting on behalf of its customer (the buyer or importer), authorizes a bank in the seller's country, known as the advising bank, to make payment to the beneficiary (the seller or exporter) against the receipt of stipulated documents.
- The LC is a separate contract from the sales contract on which it is based and, therefore, the bank is not concerned whether each party fulfills the terms of the sales contract.
- The bank's obligation to pay is solely conditional upon the seller's compliance with the terms and conditions of the LC. In LC transactions, banks deal in documents only, not goods.

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 advising 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 advising bank.
5. The advising bank checks documents for compliance with the LC and pays 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.

CHARACTERISTICS OF A LETTER OF CREDIT

Applicability

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

Risk

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

Pros

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

Cons

- Process is complex and labor intensive
- Relatively expensive in terms of transaction costs

Irrevocable Letter of Credit

LCs can be issued as revocable or irrevocable. Most LCs are irrevocable, which means they may not be changed or cancelled unless both the buyer and seller agree. If the LC does not mention whether it is revocable or irrevocable, it automatically defaults to irrevocable. Revocable LCs are occasionally used between parent companies and their subsidiaries conducting business across borders.

Confirmed Letter of Credit

A greater degree of protection is afforded to the exporter when a LC issued by a foreign bank (the importer's issuing bank) is confirmed by a U.S. bank (the exporter's advising bank). This confirmation means that the U.S. bank adds its guarantee 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 political risk of the importing country. Exporters should consider confirming 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.

Special Letters of Credit

LCs can take many forms. When an LC is issued as 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 once it has been drawn down. Standby LCs can be used in lieu of security or cash deposits as a secondary payment mechanism.

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 upon detailed terms to be incorporated into the LC.
- Determine if all LC terms can be compiled 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 nonpayment or delayed payment.