LETTERS OF CREDIT.

What is a letter of credit?

Many Exporters will not provide goods unless they receive payments in advance or are guaranteed payment by a bank. A Letter of Credit is a conditional payment guarantee provided by an Importer’s bank to the Exporter. The payment guarantee is conditional upon the Exporter providing documentary evidence of the shipment of goods in accordance with the terms of the Letter of Credit (L/C). The Importer’s bank will guarantee the payment to the Exporter either immediately upon receipt of the correct documents or at some future determinable date e.g. 60 days from sight (by the bank) of the shipping documents or 90 days from Bill of Lading date. Letters of Credit are issued subject to the Uniform Customs and Practice for Documentary Credits issued by the International Chamber of Commerce.

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

All letters of credit contain the following 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."

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 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.

Product Benefits

- The Importer's bank takes on the responsibility of paying the Exporter, reducing the administration of the accounts payable function in the Importer's office.

- The Importer's bank is only authorised to effect payment for documents that comply with the terms and conditions of the L/C. In the event that documents do not comply with the terms and conditions the bank must refer to the Importer before payment is effected.

- The provision of a bank guarantee of payment may enable the Importer to negotiate extended trade credit terms.

- Using Letters of Credit with extended credit terms may be a relatively cheap source of credit when compared to overdrafts.

- Multiple payments can be effected under one Letter of Credit.

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.

**Restrictions / Disadvantages**

It is necessary for the Importer to have a line of credit with a bank before the bank is able to issue a Letter of Credit. The amount outstanding under each Letter of Credit issued is applied against this line of credit from the date of issuance until final payment.

The Importer cannot cancel a Letter of Credit or change it without everyone involved agreeing.

The decision to pay is in the hands of the issuing bank, not the buyer.

Letters of Credit do not guarantee the quality or quantity of the goods.

**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.

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Buyer and seller agree terms, including means of transport, period of credit offered (if any), latest date of shipment, Incoterms 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, and 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.