

# SITPRO

International Trade Guides

Financial

## Letters of Credit Best Practice

# Letters of Credit - Best Practice

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This guide details the best practice for the operation of letters of credit (L/C) - also referred to by banks and other financial institutions as documentary credits. Topics covered in the guide include: negotiation; checking the letters of credit on receipt; documentation requirements; and, in the event of a worse case situation, what to do if a letter of credit is rejected by the bank on first presentation.

You should read this guide together with the guide **Letters Of Credit - An Introduction** and SITPRO's set of three **Letters of Credit Checklists and Guides** for Importers, Exporters and Export Sales Representatives. The checklist designed for importers is to be used by purchasing staff when applying to local banks for letters of credit. The one for exporters is intended primarily for use in export sales and shipping departments. The export sales representative's guide advises on credits and some of the other responsibilities assumed on overseas visits.

To ensure a letter of credit is workable, trouble-free and provides the security of payment for which the credit was requested in the first place, it is essential to take simple yet effective precautions at the start. Working through the checkpoints set out in the various sections of the guide will help reduce discrepancies and associated unplanned costs.

Successive surveys by SITPRO and others have shown that well in excess of fifty percent of documents presented by exporters to banks for payment under letters of credit are rejected on first presentation. This can cause expensive delays for both the exporter and the importer and may even result in a lesser payment or no payment at all. A great many of those rejections could be avoided if more care was taken to ensure that the documents called for in the credit are properly completed.

The SITPRO **Letters of Credit Checklists and Guides** are designed to minimise unnecessary costs and risk when trading on the basis of letters of credit. They are aligned with and based on interpretation of Uniform Customs & Practice for Documentary Credits (UCP), produced by the International Chamber of Commerce (ICC). The current revision, UCP 600, is available from ICC UK ([www.iccuk.net](http://www.iccuk.net)).

## Payment Options

The exporter should consider whether it is necessary to use a letter of credit or if another method of payment could be acceptable, desirable or more appropriate. You may wish to consider other forms of payment, such as:

- Payment in advance
  - Usually part payment up front - e.g. 40% of selling price with the remainder payable on agreed credit terms
- Documentary collection (Bills of Exchange)
- Open account (credit) terms
  - Payment made at a set period after receipt of goods or invoice

Your decision should be based on several factors:

- Company policy, including provisions made for bad debt
- Cash flow considerations
- Relationship with your overseas customer
- Market conditions where your overseas customer is based
- Your ability to meet the terms and conditions of the payment method
- Your 'gut' feeling

## The Negotiating Stage

### When dealing with a letter of credit, best practice starts before the credit is received

The terms and conditions of the credit should be agreed at the contract negotiation stage with the importer, considering the following issues:

- Should the Letter of Credit be "confirmed"?
  - This must be stipulated when it is opened
- The payment terms
  - Payable "at sight" or after an agreed period?
- Currency of payment and where it is payable
- Who pays bank charges abroad and in the UK
- Which documentation will be requested under the letter of credit?
- Expiry date of the credit
  - Allow time for production, shipment and presentation of documents to the banks (normally 21 days after shipment)

In order to ensure that all these points are considered the exporter should, where possible, complete the bank application form with their customer. Alternatively, the exporter should provide suggested wording to the importer as early as possible during the sales negotiations. On agreement, it should be built into the sales and purchase contract, reducing the likelihood that goods or payment will be delayed due to problems with the credit.

**Note:** The L/C should be kept simple and refer to rather than recreate the sales contract. For example, it is preferable to state, “goods provided as per sales contract [number]” rather than reproduce the full goods description.

## Essential Checks When the Letter of Credit is Received

Even when these steps are followed, it is essential to review the credit as soon as it is received using the following checklist:

- Is the credit subject to UCP 600?
- Are the names and addresses of the Applicant and Beneficiary complete and correct?
- Are there any terms or conditions within the credit that cannot be met?
  - If yes, immediate arrangements must be made with the Applicant for the credit to be amended
- Do the terms cited in the credit match those in the sales contract?
  - Also check that descriptions, names and addresses are consistent in both documents
- Are the prices correct?
- Are the description, price and quantity of the goods stated in accordance with the terms of the contract?
  - Under-drawing a credit may sometimes cause problems, although under certain circumstances, UCP 600 allows a tolerance of  $\pm 5\%$  on quantity.
- Can the goods be shipped within the stated period?
- Can the mode of transport specified be used?
- Can shipment be made from the port/airport specified?
- If part-shipments and transshipment of goods are prohibited, can the full quantity of the goods be exported on a vessel direct from the port of loading to the port of destination?
- Can the required documentation be obtained?
- Do any documents need to be legalised?
- Are the insurance requirements of the credit acceptable?
- Are drawings under the credit negotiable?
- Are drawings under the credit payable in the UK rather than abroad?
- Can the goods be shipped within the period specified and documents presented to the bank within 21 days from the date of shipment (unless a shorter time is stipulated) but, in any case before the credit expires?

**Note:** The documents called for should fulfil the requirements stated in the sales contract

# Compiling Documents Under a Letter of Credit

## Amount payable

- Do not overstate of the amount to be drawn as this could lead to the rejection of documents when presented
- In a credit the words "about" or "approximately" permit up to a  $\pm 10\%$  variation in the amount stated of the credit, quantity or the unit price
- Unless a credit stipulates that the quantity of the goods specified must not be exceeded nor reduced, a tolerance of  $\pm 5\%$  is permissible - provided the total amount of the drawings does not exceed the amount of the credit
  - This tolerance does not apply when the credit specifies quantities in number of packing units or individual items

## Shipment

- Can the specified shipping documentation be obtained?
- If you are chartering a vessel or shipping on deck, does the credit specifically permit such methods?
- Do the ports of shipment and discharge, if specified, conflict with your price quotations?
- If partial shipment or transshipments have to be made, does the credit allow this?
  - Any installments not shipped within a stipulated period will effectively cancel the credit
  - Partial shipments are allowed under UCP 600
  - The prohibition of transshipment is inappropriate - even if the credit prohibits transshipment, transport documents may indicate goods may or will be transhipped provided the entire carriage is covered by one and the same document
- You need to ensure that the time available for shipment and the period allowed for presentation of documents after shipment are sufficient
  - If a credit expires on a day when banks are not open, the validity is usually extended to the next working day. However, this does not apply to the stipulated time (after shipment) allowed for the presentation of documents (usually 21 days)



## Individual Documents

**Note:** Banks will not generally accept liability or responsibility for the consequences arising out of delay, loss in transit or other errors arising in delivery of documents when they are sent in accordance with the credit.

### Draft (or Bill of Exchange)

An unconditional order by which the Applicant (the party creating it) orders the Advising bank to pay money to the Beneficiary "at sight" or at a fixed time. It must be drawn in accordance with the terms of the credit, bear the requisite reference number and also comply with the requirements in the Bills of Exchange Act and/or flowing from the rules agreed in the Convention Providing a Uniform Law For Bills of Exchange and Promissory Notes (Geneva Convention, 1930).

You should check that it is:

- Correct in words and figures
- Correctly dated
- Drawn for immediate payment "at sight" or at a given future time
- Claused in accordance with the credit terms

### Transport Documents

There are a number of types of transport document, e.g. sea, air, road, rail, inland waterway, multimodal, courier or postal despatches. The most traditional is the Bill of Lading, which has a threefold purpose: i) formal receipt by the ship owner for goods; ii) evidence of the contract of carriage; and iii) Document of title to goods. In some cases house bills of lading or house air waybills (HAWBs) may also be used against a letter of credit.

- Transport documents may be issued by any party, including freight forwarders, other than a carrier, owner, master or charterer
- Short form or blank back transport documents are acceptable

## Points to check

- The document should:
  - Indicate the name of the carrier and be signed by the carrier, master or named agent
  - Indicate the goods have been dispatched, taken in charge or shipped on board at the place stated in the credit
  - Indicate the place of dispatch, taken in charge, ports of loading and discharge, and/or the final destination stated in the credit
- Consignor - can be different from the seller
- Consignee - can differ from buyer
- "On deck" clause should state goods may be loaded on deck - it must not state that goods are or will be loaded on deck
- Free from any detrimental clauses (i.e. bearing no clause or notation expressly declaring a defective condition of the goods or packaging) - banks will only accept clean transport documents
- Goods description - either in general or particular terms
  - The wording chosen must not conflict with the credit or other documents
- The places of acceptance and delivery and, if a bill of lading, the ports of loading and discharge
- Date of issuance - deemed to be the date of dispatch, taking in charge or shipment, unless otherwise indicated
- Shipment date is on or before the last stipulated shipment date but, in any event, within the validity of the credit
- Present the documents within the time limit specified in the credit
  - If no such period is stipulated, banks will refuse documents presented later than 21 days from the date of the transport document
- Transshipment: the prohibition of transshipment is inappropriate
  - Under UCP 600 Articles 19-24 (the transport articles), transport documents may indicate goods may or will be transhipped provided the entire carriage is covered by one and the same document, even if the credit prohibits transshipment
  - For maritime shipments, it only applies to containers, trailers or LASH barges
- Endorsed as may be stipulated in the credit
- Sole or full set of originals

## Insurance documents

Points to check:

- The extent of the cover agrees precisely with the credit terms
  - If "all risks" is stipulated, banks will accept any "all risks" notation or clauses on insurance documents - "all risk" does not mean all risk and may not cover special risks
- Correct number of and type, e.g. certificate or policy, of insurance documents as stipulated in the credit
  - Cover notes are not acceptable
- Date of insurance document no later than date of shipment - unless cover takes effect from date of shipment
- The amount payable is in accordance with the credit terms plus any specified percentage and is in the same currency as the credit
  - The amount must be at least 110% of the CIF or CIP value of the goods
- Marks, weights and description of the goods do not conflict with the wording in the credit or other documents
- The policy or certificate required by the credit terms is signed by the insurance company, agents or underwriters and endorsed as necessary
- Endorsed, if necessary, exactly as required by the credit

## Invoice

Points to check:

- Description of goods including: import licence or pro-forma details; price; terms of delivery and shipment; and any no-charge goods or samples agree with, are worded and spelt exactly as set out in the credit
  - You only need enough detail for basic identification, no more
  - If goods are described as being, "...in accordance with pro forma invoice number ... dated..." this can reduce superfluous, error-producing detail
  - Prices should be in the same currency as the credit
- Clauses or statements must be copied word for word and identically spelt
- Use of any foreign language must be specified
- Totals of all invoices must agree with the amount of the drawing
  - Value not more than the credit permits and the same as any bill of exchange - under certain conditions you may be able to underdraw by up to 5%
- The invoice heading must contain your company's name and address expressed and spelt exactly as in the credit
- The invoice must be made out in name of Applicant, expressed and spelt exactly as in the credit
- If a combined invoice and certificate of origin is called for, the certificate of origin is duly completed and signed

- If invoices have to be visaed, this has been done by the authority stipulated in the credit
  - **Note:** The time lag between forwarding documents to a consulate and their return
- If both an invoice and a packing list are called for, no "combined invoice and packing list" should be offered
  - An appropriately detailed extra invoice may often satisfy the packing list need, if suitably headed
- Pro forma invoice numbers or reference numbers required by the credit are shown
- Where they are required to be signed, certified or legalised, precise instructions should be given

## Certificates of origin

Points to check:

- The certificate is certified by the authorising body
- All details quoted, shipping marks and description of goods agree with the Letter of Credit, transport and other documents
- The certificate does not conflict with other documents with regard to value and country of origin

## Weight note/list

Points to note:

- Certificates of weight must bear an authorised signature of the person/firm/company issuing the certificate in the detail required
- If a weight list is called for by the credit, this requires the individual weight of each parcel or package together with the total weight
- If a weight note is called for by the credit it can merely state the weights concerned in general terms - perhaps one total

## Courier receipt or Post receipt

Points to check:

- A courier receipt must indicate
  - The name of, and stamped or signed by, the courier service
  - A date of pickup or receipt
- A post receipt must
  - Show evidence of despatch to the party named in the credit
  - Must be stamped or signed and dated
  - The credit does not call for postal despatch on a FOB basis: postal charges have to be prepaid

## What To Do If Documents Are Rejected

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A bank has a maximum of 5 banking days after the day of presentation to determine if the presentation is compliant. The bank can refuse to honour or negotiate the credit. If they do so, contact them immediately.

Should the documents be rejected, do not panic, you have the following options:

1. To correct the documents
2. To instruct the Advising bank to request the Issuing bank for permission to pay despite the discrepancies
3. To offer the bank an indemnity if they will pay despite the discrepancies
4. To send documents to the Issuing bank on a collection basis

Options 1 and 2 are best as they maintain the security of the letter of credit. On Option 3, the exporter may have to repay the money if the importer refuses to pay for discrepant documents. Under Option 4, all security is likely to be lost.

A letter of credit is a quick and secure way of getting paid by your customer provided all the necessary precautions are taken to minimise the risks of discrepancies. It only takes a moment of carelessness to erode the security of using this method of payment and place an exporter in an awkward situation vis-à-vis his customer.



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UCP600 contains the rules for the use of letters  
of credit. Where there are any inconsistencies  
with this guide, UCP600 will prevail.