SITPRO Briefings

Financial

Letters of Credit
An Introduction

SITPRO
Simplifying International Trade

Who Is This Briefing For?

You should read this Briefing if you are involved in the obtaining payment for your company's overseas trade transactions. You may wish to pass on the information in the Briefing to your colleagues in Sales & Marketing and Finance Management and Credit Control.

What Does This Briefing Tell Me?

This Briefing explains what is a Letter of Credit (L/C), commonly referred to by the Banks and other financial institutions as a Documentary Credit. Also it tells you what types of L/C are available and the internationally agreed that govern its operation.

You should read this Briefing together with the Briefing on the Best Practice in Letters of Credit and the SITPRO set of three Checklists and Guides for the Exporter, the Export Sales Executive and the Importer.

SITPRO range of Checklists and Guides are designed to minimise unnecessary costs and risk when trading on the basis of letters of credit. They are aligned with the 1993 revision of the ICC "Uniform Customs and Practice for Documentary Credits" (commonly known as UCP 500), the current edition of the worldwide "rules".

Working through the checkpoints set out in the various sections will help reduce discrepancies; associated unplanned costs; and the risk of losing the whole basis of secured payment for which the credit was established in the first place.

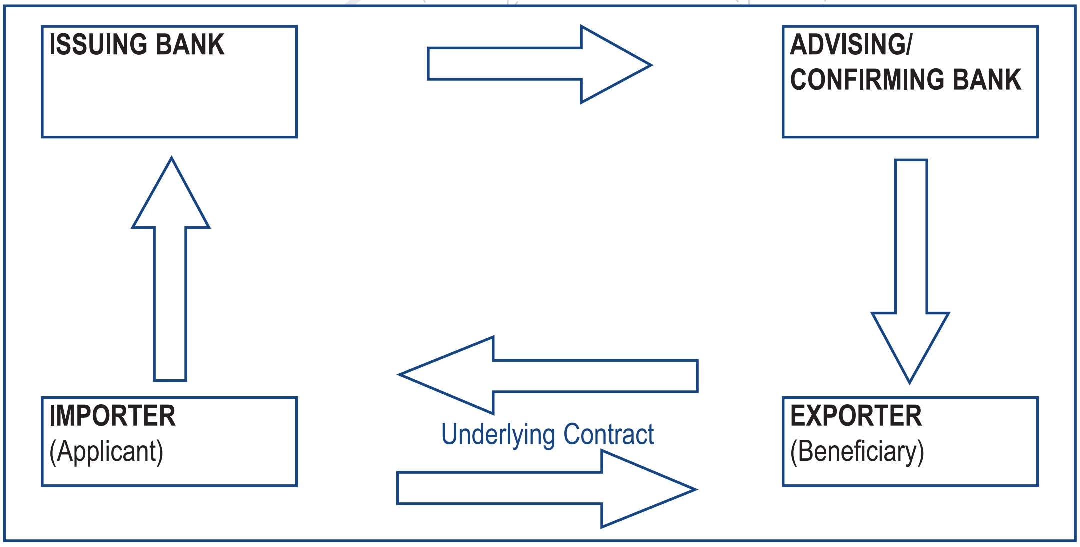
As successive SITPRO and other surveys have shown, well in excess of 50% of presentations are rejected by banks at first presentation. This percentage is considered by many to be a very conservative estimate. As the resultant cost both to the individual exporter and the UK economy is high, it is essential for credit transactions to be handled correctly from contract stage to actual drawdown - by following the recommendations here.

Definition

In simple terms, a letter of credit is an undertaking by a bank to make a payment to a named beneficiary within a specified time, against the presentation of documents which comply strictly with the terms of the letter of credit.

Its main advantage is providing security to both the exporter and the importer, but the security offered, however, comes at a price and must be weighed against the additional costs resulting from bank charges. The exporter must understand the conditional nature of the letter of credit and the fact that payment will not be made unless the terms of the credit are met precisely.

A letter of credit is opened by an importer (applicant), to ensure that the documentation requestedreflects and proves that the seller has performed under the requirements of the underlying sales contract, by the exporter by making them conditions of the letter of credit (N.B. The sales contract is **not** an inherent part of the Letter of Credit, although the Letter of Credit may contain a reference to such contract). For the exporter a letter of credit, apart from cash in advance, is the most secure method of payment in international trade as long as the terms of the credit are met. The following diagram shows those involved in a Letter of Credit transaction:



When an exporter asks for payment by letter of credit, he is transferring the risk of non-payment by the buyer to the issuing bank (and the confirming bank if the letter of credit is confirmed), providing the exporter presents the required documents in strict compliance with the credit.

An importer should only be thinking of opening a letter of credit if his country's exchange control regulations require it or if his supplier insists upon it. It is worth noting that over 50% of letters of credit are rejected on first presentation, which can cause expensive delays for both the exporter and importer. Up to one half of these rejections could have been avoided if more care was taken to ensure the credit properly represented the sales contract.

Exporters will need to be certain that it is necessary to use a letter of credit. Typical considerations include:

- Is it a legal requirement in the importing country?
- What is the value of the order - will the bank charges be out of proportion to the value?
- 'Always Traded This Way' - always using letters of credit for a particular customer or region without periodically re-assessing the reasons for requesting this method of payment
- What is the credit rating of the importer and are they a new customer or has a trading relationship already been established?

- What is the country risk of the importing country (would a confirmed letter of credit be more suitable)?
- What is the standing of the issuing bank (would a confirmed letter of credit be more suitable)?
- What is the usual practice in trading with that country and in that particular commodity?
- Are there any other measures that could be taken to protect the exporter (e.g. credit insurance)?
- Insistence by a Credit Insurer to trade on letter of credit terms with buyers in certain markets.
- Recommendation by banks who may advise that the best method of payment is a 'confirmed irrevocable letter of credit' irrespective of the country, strength of issuing bank and without much regard to the value of the consignment.
- Strategic Decision Made by the Exporter - however, this strategy should be flexible to adapt to the changing risk profile of both the country and the buyer.

It is important to remember that all parties in the letter of credit transaction deal with documents, not goods.

Types of Letter of Credit

Revocable

A revocable letter of credit can be amended or cancelled at any time by the importer without the exporter's agreement (unless documents have been taken up by the nominated bank). Little protection is offered to the exporter with a revocable credit and they are rarely seen.

Irrevocable

An irrevocable letter of credit can neither be amended nor cancelled without the agreement of all parties to the credit. Under UCP500 all letters of credit are deemed to be irrevocable unless otherwise stated. Here, the importer's bank gives a binding undertaking to the supplier provided all the terms and conditions of the credit are fulfilled.

Unconfirmed

An unconfirmed letter of credit is forwarded by the advising bank directly to the exporter without adding its own undertaking to make payment or accept responsibility for payment at a future date, but confirming its authenticity.

Confirmed

A confirmed letter of credit is one in which the advising bank, on the instructions of the issuing bank, has added a confirmation that payment will be made as long as compliant documents are presented. This commitment holds even if the issuing bank or the buyer fails to make payment. The added security to the exporter of confirmation needs to be considered in the context of the standing of the issuing bank and the current political and economic state of the importer's country. A bank will make an additional charge for confirming a letter of credit.
Confirmation costs will vary according to the country involved, but for many countries considered a high risk will be between 2%-8%. There also may be countries issuing letters of credit which banks do not wish to confirm - they may already have enough exposure in that market or not wish to expose themselves to that particular risk at all.

Standby Letters of Credit

A standby letter of credit is used as support where an alternative, less secure, method of payment has been agreed. They are also used in the United States of America in place of bank guarantees. Should the exporter fail to receive payment from the importer he may claim under the standby letter of credit. Certain documents are likely to be required to obtain payment including: the standby letter of credit itself; a sight draft for the amount due; a copy of the unpaid invoice; proof of dispatch and a signed declaration from the beneficiary stating that payment has not been received by the due date and therefore reimbursement is claimed by letter of credit. The International Chamber of Commerce publishes rules for operating standby letters of credit - ISP98 International Standby Practices.

Revolving Letter of Credit

The revolving credit is used for regular shipments of the same commodity to the same importer. It can revolve in relation to time or value. If the credit is time revolving once utilised it is re-instated for further regular shipments until the credit is fully drawn. If the credit revolves in relation to value once utilised and paid the value can be reinstated for further drawings. The credit must state that it is a revolving letter of credit and it may revolve either automatically or subject to certain provisions. Revolving letters of credit are useful to avoid the need for repetitious arrangements for opening or amending letters of credit.

Transferable Letter of Credit

A transferable letter of credit is one in which the exporter has the right to request the paying, or negotiating bank to make either part, or all, of the credit value available to one or more third parties. This type of credit is useful for those acting as middlemen especially where there is a need to finance purchases from third party suppliers.

Back-to-Back Letter of Credit

A back-to-back letter of credit can be used as an alternative to the transferable letter of credit. Rather than transferring the original letter of credit to the supplier, once the letter of credit is received by the exporter from the opening bank, that letter of credit is used as security to establish a second letter of credit drawn on the exporter in favour of his importer. Many banks are reluctant to issue back-to-back letters of credit due to the level of risk to which they are exposed, whereas a transferable credit will not expose them to higher risk than under the original credit.

Uniform Customs and Practice for Documentary Credits (UCP)

Most letters of credit are subject to UCP 500, which are the universally recognised set of rules governing the use of the documentary credits in international trade. UCP were originally formulated in 1933 by the International Chamber of Commerce (ICC) and last updated in 1993 (ICC publication 500). All definitions and general documentary requirements referred to in this briefing are in accordance with UCP500 unless otherwise stated (it should be remembered that in some instances this may differ from national law). SITPRO would only recommend using letters of credit which are subject to UCP500.

It is important to negotiate, at contractual stage if possible, which party will bear bank charges. It is worth remembering that on a small transaction these may be totally out of proportion and if these costs are not included in the pricing any profit may be completely eroded.

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