

Export Practice:

Letters of Credit

Introduction

Letters of credit are bank guarantees to pay a seller (usually an exporter) for goods or services that the seller has shipped to a buyer (usually an importer). The letters are obtained from the bank by the importer as a way to assure the exporter that it will be paid. They substitute the credit of the issuing bank for the credit of the buyer. That is, the bank takes on the obligation to pay for the goods.

The exporter receives payment as long as he can show proof that he has sent the goods as agreed. The importer thereby has assurances that the exporter will ship the goods before receiving payment. Letters of credit are most often used in international trade when the importer is unknown to the exporter, or where political risks

How Letters of Credit Work

A letter of credit typically involves five parties: an importer and its bank, an exporter and its bank, and a carrier. In simplified form, this is how it works:

The **importer** – typically at the request of the exporter – buys a letter of credit from its bank, called the **issuing bank**. The fee that the importer pays for this letter depends on its creditworthiness, but can range from 1 %-8% of the value of the goods.

The issuing bank sends this letter to the **exporter**. The exporter now has assurance that he will be paid by the issuing bank.

At the same time, the issuing bank arranges for an **advisory bank** in the exporter's country – typically the exporter's own bank – to transfer the agreed payment to the exporter when the exporter has shown proof that the goods have been shipped.

The exporter then consigns the goods to a **carrier**, in exchange for a bill of lading. The exporter then gives the bill of lading to the advisory bank, in exchange for payment for the goods he has shipped.

The advisory bank then forwards the bill of lading to the issuing bank, and receives payment for the goods. The issuing bank then presents the bill of lading to its customer, the importer, as proof that the goods have been sent. The issuing bank is then paid by the importer.

The key to this system is the precision of the documents involved, including the original contract of purchase and sale, the letter of credit itself, and the bill of lading. The details of all these documents – including credit amounts, payment deadlines, serial numbers of the products sold, etc – must match-up perfectly, to ensure that all the payment flows take place as planned.

Types of Letters of Credit

In practice, letters of credit come in several varieties, and it is important for exporters to be aware of exactly what kind of letter the importer has obtained.

■ Irrevocable/Revocable Letters of Credit

An irrevocable letter of credit cannot be cancelled before a specific date without agreement by all the parties involved. A revocable letter of credit can be amended at any time by the issuing bank. Letters of credit are automatically considered irrevocable unless they expressly state otherwise.

■ Confirmed/Unconfirmed Letters of Credit

A confirmed letter of credit gives the exporter a double guarantee of payment, one from the issuing bank and one from the advisory bank. Under a confirmed letter of credit, the advisory bank agrees to pay the exporter for the goods, even if the issuing bank ultimately fails to honour its obligations. An unconfirmed letter, in contrast, offers no express guarantee by the advisory bank. Letters of credit are usually unconfirmed. Confirmed letters are used when an exporter has doubts about the issuing bank's ability to pay – perhaps because of potential currency restrictions in the importers' country.

■ Transferable Letters of Credit

A transferable letter of credit is used when the exporter is essentially a middleman between a product manufacturer and an importer. The exporter (ie, the middleman) may not want the manufacturer to know the identity of the importer, to avoid enabling the two parties to "eliminate the middleman". In this case, the exporter will request a transferable letter of credit, and uses it to guarantee payment to the manufacturer. Once he has paid the manufacturer, the exporter can use the letter to receive payment for the export. Transferable letters require the agreement of the importer and the issuing bank. Only one transfer per letter is allowed.

■ Back-to-Back Letters of Credit

If a transferable letter is not possible, then back-to-back letters of credit can be used. This involves two parallel letter of credit transactions, one involving the middleman and manufacturer, and the other involving the middleman and his end-buyer (usually an importer in another country). These two transactions are independent of each other. However, the letter issued by the importer's bank can offer security to the middleman's bank that its letter (guaranteeing payment to the manufacturer) will ultimately be covered by the export sale.

■ Standby Letters of Credit

A standby letter of credit is a second line of defence for exporters, in cases where an importer has an open (revolving) line of credit, has received advance payment in some form, or otherwise has ongoing contractual obligations to the exporter. A standby letter is usually issued in addition to the regular letter of credit. Under a standby letter, the issuing bank agrees to pay the exporter in case the importer fails to perform as called for by the contract. It thereby strengthens the importer's creditworthiness in the eyes of the exporter.

■ Sight/Deferred Payment Letters of Credit

Sight letters of credit are payable as soon as the required documents have been presented. Usually, however, seven days are allowed under such letters, to permit the banks to examine the documents in detail. A deferred payment letter of credit allows the importer to take possession of goods by agreeing to pay the issuing bank or the advisory bank at a future date, for example 60 days after the date of shipment. The issuing and advisory banks state that they will pay the exporter on the agreed future date. Deferred payment letters serve as financing instruments for the importer. He can, during the waiting period, sell the goods onward and use the proceeds to pay for the import.

■ Revolving Letters of Credit

Under a revolving letter of credit, the issuing bank establishes a line of credit to the importer, and restores the credit to its original amount once the importer has drawn it down. Usually these arrangements limit the number of times the importer may draw down its line over a predetermined period.

■ Red Clause Letters of Credit

These letters provide the exporter with cash prior to shipment, to finance production of the goods. The issuing bank may advance some or all of the funds. The importer is essentially financing the exporter, and takes on the risk for all advance payments

Points to Consider When Using Letters of Credit

The key to successful use of letters of credit is proper documentation. This requires paying close attention to the fine print on such matters as description of the goods, deadlines for delivery of goods and payment, price of goods, etc. All the details of the sales contract, letter of credit and bill of lading must be consistent. Common sources of errors are details such as the number of items shipped, the weight of goods, the shipment dates, product serial numbers, and document reference numbers.

Exporters must ensure they can meet their own delivery obligations before relying on letters of credit to ensure payment, since their own non-performance could cancel the importer's obligations. Such non-performance could occur through no fault of the exporter – for example, if it discovers belatedly that it cannot export the goods due to import restrictions in the importer's country. It is up to the exporter to determine in advance whether such external factors could threaten the viability of an export deal.

The terms of a letter of credit should allow sufficient time for the payment flows to take place – otherwise the letter could be nullified due to missed deadlines. If necessary, exporters should ask for a clause in the letter that allows an extension of time in case of delays in electronic bank-to-bank transfers.

A letter of credit is used as a guarantee in case of doubts surrounding the importer's ability or willingness to pay. With that in mind, exporters should consider the degree of risk involved before asking for a letter of credit. For example: What is the value of the order, and would the bank fees be out of proportion to the value? What is the credit rating of the importer, and is this importer entirely unknown to the exporter? What is the country risk of the importing country? How credit-worthy is the issuing bank? What is the usual practice in trading with this country or in this line of products? Should additional protective measures be taken, such as credit insurance?

Pros and cons of Letters of Credit

For exporters, letters of credit offer guaranteed payment; the exporter receives the issuing bank's promise to pay, to back-up the importer's promise to pay. This can be a significant factor when dealing with unknown customers and/or risky countries.

In many cases exporters have no choice but to require an importer to obtain a letter of credit. It might be a legal requirement in the importing country, or it may be a requirement of the exporter's credit insurer. In the latter case, the insurer would pay the exporter if the advisory bank fails to pay for goods shipped.

While letters of credit offer exporters security of payment, they present several drawbacks. They are potentially costly to the importer, which in turn could make the exporter uncompetitive vis-à-vis other exporters who do not demand letters of credit. Moreover, in many cases the importer asks to transfer part or all of the bank fees to the exporter. If a confirmed letter is used, the confirmation costs could add another 2%-8% to the final tally of bank fees.

There is also a cost to exporters in terms of the time required to check documents and ensure they are error-free and internally consistent. Letters of credit involve a large amount of fine detail, and payment will only be made if the terms of the letter are met precisely. Exporters should consider whether the size and risks of a particular deal justify this cost, or whether they might do better with an alternative method.

There is a broad range of alternatives, each posing different degrees of risk. Under advance payment, the exporter bears no risk because the importer pays for goods in advance. With an open account, in contrast, the exporter bears all the risk, because the importer agrees to pay only when goods are received. In between are such arrangements as documentary collection, in which documents, including a bill of exchange (a written order from the exporter to the importer to pay) are sent through the banking system. The bank presents the documents to the importer and – if all goes well – receives payment, which it then passes on to the exporter. Many exporters also choose credit insurance. This typically covers up to 90% of the invoice value, but the process of receiving payment is much less time consuming than with a letter of credit.